

**PBGC PROPOSAL TO INITIATE A VARIABLE RATE PREMIUM
SYSTEM; AND PUBLIC COMMENTS ON ADMINISTRATION'S PEN-
SION PLAN FUNDING AND PREMIUM RATE PROPOSALS**

HEARINGS
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDREDTH CONGRESS
FIRST SESSION

APRIL 7 AND 9, 1987

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**PENSION BENEFIT GUARANTY CORPORATION'S
PROPOSAL TO INITIATE A VARIABLE RATE
PREMIUM SYSTEM**

TUESDAY, APRIL 7, 1987

**HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
*Washington, DC.***

The subcommittee met, pursuant to notice, at 9:19 a.m., in room 1100, Longworth House Office Building, Hon. J.J. Pickle (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
MONDAY, MARCH 23, 1987

PRESS RELEASE #5
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-5522

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING ON
THE PENSION BENEFIT GUARANTY CORPORATION'S PROPOSAL
TO INITIATE A VARIABLE RATE PREMIUM SYSTEM

The Honorable J. J. Pickle, (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold a hearing to review the Administration's proposed legislation providing that the Pension Benefit Guaranty Corporation (PBGC) initiate a variable rate premium system under which higher premiums would be charged to those employers who do not adequately fund their pension plans. The Subcommittee will receive testimony from representatives of the PBGC to discuss the details of the Administration's premium rate proposal. The hearing has been scheduled for Tuesday, April 7, 1987, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:15 a.m.

In announcing the hearing, Chairman Pickle made the following statements: "The PBGC's proposal to establish variable premium rates is one piece of our overall effort to bring financial stability to the defined benefit pension system. I look forward to considering the PBGC's proposal on its own merits, and in the context of the broader reform effort.

"For quite some time I have been concerned about the steady deterioration in the financial condition of the PBGC, whose deficit now approaches \$4 billion. To better understand the significance and causes of this deficit, I asked the General Accounting Office (GAO) to provide this Subcommittee with additional information on the financial condition of the PBGC. In its report, Pension Plans: Government Insurance Program Threatened by Its Growing Deficit, prepared for the Subcommittee and released last Friday, the GAO found that it is unlikely the present annual premium of \$8.50 will be enough to retire the PBGC's current deficit, much less pay for claims arising from future plan terminations. In light of this finding, I believe it is imperative that we fully consider the PBGC's proposal to charge higher premiums to employers who do not adequately fund their pension programs.

"I also have asked the Congressional Budget Office (CBO) to report to the Oversight Subcommittee on the financial status of the PBGC and policy alternatives. I look forward to their analyses."

Chairman PICKLE. The subcommittee will come to order. I ask that our guests please take their seats, and we will start the hearing.

The Subcommittee on Oversight has scheduled hearings for today and Thursday of this week to discuss issues affecting the single-employer defined benefit pension system. This system is vital to the retirement security of over 30 million workers and retirees covered by over 110,000 pension plans nationwide.

As a result of our tax laws and the willingness of employers and workers to put money aside for retirement, these pension plans have accumulated assets of nearly \$1 trillion, a sum which exceeds our national budget. This is a staggering amount of money, and it must be watched carefully. The purpose of these hearings is to consider options for improving our pension system. We need to better protect the benefits due to participants and to more fairly treat employers who responsibly fund their plans.

Last month, this subcommittee heard from the Department of Treasury, the Department of Labor, the Internal Revenue Service, and the Pension Benefit Guaranty Corporation on the administration's single-employer pension plan funding and termination proposal. Today, as the subcommittee's first witness, the PBGC will present the administration's variable-rate premium proposal—or at least, I presume primarily it will be about the question of rates and what kind of rates.

Ms. UTGOFF. Yes.

Chairman PICKLE. At the outset, I want to emphasize my view that any solution to the financial problem of the PBGC should include more than just a premium increase. It must also address the problems presented by overfunded and underfunded pension plans. All three areas need to be considered as part of a single, well-coordinated reform package.

The issues to be discussed today are mammoth in size. PBGC has a deficit of nearly \$4 billion. What do we do about it? Everyone knows all too well that we increased the employer premium rate from an initial \$1 per participant per year in 1974 to \$2.60 in 1977, and to \$8.50 in 1986. We are now told that these premium rates are not sufficient to cover program costs. Something is wrong—at least, we have got a serious problem now, and particularly as it lies ahead.

Currently, the total unfunded liability of underfunded plans exceeds \$45 billion. Most of this liability is concentrated in a small number of very large plans. Clearly, it was the termination of several large and badly underfunded plans which caused the PBGC's deficit to triple in the past 2 years.

Our question today is, what should we do to prevent or prepare for the termination of more of these plans in the future, assuming that they are ahead of us.

At the opposite end of the scale, we are told that overfunded plans currently have more than \$260 billion in excess assets. This is big money. It is so big that employers are terminating their plans just to get it. We are told that asset reversions totaled almost \$16 billion from 1980 to 1986, with over \$10 billion in the last 2 years. We must ask ourselves is this trend a good one, and what is its impact.

Earlier this year, I asked the General Accounting Office and the Congressional Budget Office to prepare reports on the reasons for the PBGC's growing deficit and on the appropriate reforms which the Congress should consider. I look forward to hearing from them today.

Most importantly, our hearings will focus on those directly affected by the current pension plan rules. Witnesses will represent the interests of employers, employees, retirees, and those responsible for administering plans. I urge each witness today to provide this subcommittee with comments on the positive and negative aspects of the administration's proposals and to identify alternatives that the subcommittee should consider in developing a reform package.

The Chair will now ask Mr. Schulze if he has an opening statement.

Mr. SCHULZE. Thank you, Mr. Chairman.

I am pleased to join you in continuing the subcommittee's examination of the administration's pension proposals.

The administration's pension proposals are in two major parts. The first part concerns the funding and termination of defined benefit pension plans. On March 6, the administration presented the details of this proposal. Later today and on Thursday, we shall receive public testimony on this issue. I am anxious to learn how the private sector responds to it.

The second part of the administration's pension proposal concerns a variable-rate risk-related premium for the Pension Benefit Guaranty Corporation. Today the administration will unveil this long-awaited proposal. We are eager to learn the details.

The PBGC's deficit has increased at a sobering rate. At the end of 1985, the PBGC deficit was about \$1.3 billion, but by the end of 1986, it had risen to \$3.8 billion. Pension plan terminations by employers in steel and aerospace industries are responsible for a large part of this increase. The worsening financial condition of the PBGC has occurred despite recent premium increases. Just last year, the premium was increased from \$2.60 to \$8.50 per plan participant. Current projections suggest that even with such premium increases, the PBGC may exhaust its reserves in about 15 years.

The variable-rate PBGC premium proposal and the proposal for the funding and termination of defined benefit pension plans are technically separate proposals; however, as a policy matter, the two proposals complement one another.

It is unfair to responsible pension plan sponsors to keep increasing their premium in order to cover PBGC liabilities due to imprudent pension plan sponsors. A comprehensive approach to this issue should address the ability of plan sponsors to maintain seriously underfunded plans as a part of an effort to increase further the PBGC premium.

Mr. Chairman, I am looking forward to receiving today's testimony.

Chairman PICKLE. Thank you, Mr. Schulze.

Let the Chair make one or two observations at this point, before we start.

We have, I believe, Dr. Utgoff, and then two or three panels. We also will have a markup in the Health Subcommittee this after-

noon, starting at two, and I believe a markup also in the Welfare Subcommittee.

We therefore will ask the witnesses and others to be as brief as they can without being cut short of the proper time, and I will ask the members to stay with us as regularly as they can, so that we can proceed rapidly and finish our work before that time this afternoon.

We will have another hearing Thursday of this week, and so far as the chairman is concerned, this may complete the number of hearings, because we will have had four hearings on the question of pension and pension plans.

It is the hope, then, that we can make some conclusion as far as recommendations or analysis within the next 30 days so that we might make some kind of a recommendation or comment before the reconciliation bill, Mr. Schulze. So I am saying to the committee that probably in another 30 days, we will try to make some commentary or some affirmative statement on this question.

Now, as we proceed, I want to say to Dr. Utgoff that for a year or two at different times when you and others have come up from PBGC, you have just asked for more money, and that is all you have asked for, basically. We have asked you to give us some plans or something in the way of reform as we consider premiums.

Well, now, you have done that. The Treasury and the PBGC officers have given us some plans for us to consider. In general, I think it is a good, positive set of recommendations. How we will react to them is something I am not sure of. But before we start, Dr. Utgoff, I want to tell you that I appreciate the fact that you are coming up now, you and Treasury, to say here is a plan we think will help shore the pension plans up. We have got to do something; we know that. So I appreciate the cooperation we are having, and I look forward to your statement today.

So, Dr. Utgoff, if you will proceed, we will be pleased to have your testimony.

STATEMENT OF KATHLEEN P. UTGOFF, PH.D., EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION (PBGC)

Ms. UTGOFF. Thank you, Mr. Chairman, for this opportunity to testify about the administration's proposal to establish a variable-rate premium for the Pension Benefit Guaranty Corporation.

This proposal, which is being transmitted to Congress this week, is vital to the survival of the PBGC's single-employer insurance program, which covers 110,000 pension plans and protects over 30 million American workers.

The PBGC is now responsible for the payment of benefits to 355,000 plan participants in the 1,350 plans that have already terminated without enough assets to cover guaranteed benefits.

Today, the PBGC's deficit is \$3.8 billion. The PBGC's single-employer insurance program is in serious financial trouble. We can continue to pay retirement benefits in the immediate future, but our financial crisis is very real. Our annual premium receipts are \$280 million. We project benefit payments of \$590 million in fiscal year 1987 and \$820 million in fiscal year 1988. This year, we are paying out more in benefit payments than we are receiving in pre-

miums and investment income. This means that assets of newly terminated plans that we are acquiring are now being used to pay retirees who were participants in plans that terminated years ago. We will soon be dependent on liquidating assets to meet our monthly benefit obligations.

Sooner or later, something must be done to increase the Corporation's revenues. Waiting until later means that we will need to raise more revenue in a shorter period. And that would mean a very large premium increase. The time to act is now.

When the Single-Employer Pension Plan Amendments Act of 1986 was enacted 1 year ago today, the PBGC was directed to conduct a study of premiums and the premium-setting procedure under current law. This week, in compliance with that directive, we are submitting to the Congress a premium study with the PBGC's recommendations for changing its premium structure. We are also transmitting a legislative proposal for that variable-rate structure.

The proposal before the committee today will accomplish four important objectives. First, it will provide the revenue that the PBGC needs in order to continue to be the safety net for pension promises made to American workers. Second, it will raise this revenue in a way that equitably allocates premium costs. Third, it will create incentives for better funding. And fourth, it will keep premiums at the lowest possible level consistent with the restoration of the PBGC's health.

Let me describe why the change we are proposing is needed. Ever since the PBGC was established, it has charged every insured plan the same amount per participant, despite wide variations among plans in funding levels and risk of termination. Congress initially set the rate at \$1 per participant per year. That premium seemed reasonable in light of a study in 1972 of plan terminations that was conducted by the Departments of Labor and Treasury, which indicated that annual insurance claims against the PBGC could be expected to be in the neighborhood of \$30 to \$40 million a year.

By 1977, claims had substantially outstripped these projections. Congress reacted by raising the per capita rate to \$2.60, effective January 1, 1978. Once again, however, claims were higher than forecast. In 1982 the PBGC came back to ask for another premium increase, which was enacted as part of the Single-Employer Pension Plan Amendments Act of 1986. Unfortunately, by the time that premium increase was enacted, two large terminations had occurred that made the \$8.50 premium inadequate. Since that time, the LTV terminations have magnified the PBGC's deficit.

The reason for this sobering progression of increasing premium rates and mounting deficits is not simply bad forecasting. The PBGC's insurance program has changed incentives, and some employers have responded to these changed incentives. With the PBGC, an employer that maintains an underfunded pension plan can make promises to its employees even if it will never be able to fund the benefits that it has promised. Without the PBGC, underfunded pension promises would be worth little or nothing. But with the PBGC, they have real value. Often, they are as valuable as the promises of employers that fully fund their pensions. In effect, the

current system allows a few employers to pay for their pension promises with other employers' premium dollars.

So long as the PBGC insurance program has these characteristics, claims against it will be uncontrollable, and uncontrollable claims will lead to uncontrollable premiums. When this happens, responsible companies may not willingly continue to underwrite irresponsible companies' pension promises. At some point, the responsible companies may decide that their premium dollars can be used better elsewhere. They may replace their defined benefit pension plans with other arrangements. When companies with well-funded plans leave the program, the premium burden will rest on fewer and fewer shoulders, inducing the remaining companies with well-funded plans to simply "rush to the door." That would end any semblance of a sound financial base for the PBGC.

Clearly, higher flat-rate premiums are not the answer to this problem, because they may drive responsible employers from the system. But we must raise additional revenue, and we must do so soon.

The administration believes that the best way to make this system workable is a variable-rate premium that charges more to underfunded plans. Under such a premium structure, a well-funded plan would not pay the same premium as a plan that has tens of thousands of dollars of unfunded pension promises per participant. This is not a new idea—it was considered when ERISA was being developed, the Grace Commission recommended it, and the Congress specifically asked the PBGC to study the concept. We have also received a steady stream of mail from plan sponsors objecting to the flat-rate premium and urging a more equitable system.

Let me describe the proposed premium structure.

The premium structure that we are proposing is a relatively simple one. It is a variant of a true risk-related premium. It does not require a complicated assessment of the likelihood of employers' terminating underfunded pension plans. Premiums would be based on the unfunded benefit exposure that a plan represents to the insurance program.

All covered plans would pay a flat, per-participant charge. Plans that represent greater exposure would also pay a variable funding charge.

The flat-rate portion of the premium would be set at the current premium level—\$8.50 per participant. This amount would be indexed to changes in the Social Security contribution and benefit base, the same base that is used to adjust the maximum benefit guaranteed by the PBGC.

The second part of the premium is a funding charge. A plan would pay this charge only if it had 100 or more participants and was less than 125 percent funded for vested benefits. The funding charge initially would be \$6 per \$1,000 of funding below the 125-percent level.

There are several important limitations on the funding charge. First, the charge would not apply to any plan that had fewer than 100 participants. Second, the total premium—flat rate plus funding charge—would be initially limited to \$100 per participant. This cap would increase at 1.5 times the rate of increase of the Social Security wage and contribution base. Limiting the maximum premium

will ease the immediate burden of the increase for plans subject to the funding charge. The cap will very gradually increase in real terms and thus will be phased out over a long period of time. Third, benefits for which a plan has purchased insurance company annuities would be disregarded for the purpose of calculating the funding charge. Fourth, a similar rule would apply if the plan sponsor gave the PBGC a security interest in assets equal to the amount of its plan's underfunding plus a cushion.

The funding charge would be adjusted upon review every 3 years to permit reduced premiums when the single-employer program's experience is more favorable than anticipated and increased premiums when experience is worse than anticipated. Only the funding charge would be adjusted, and by no more than 50 percent, as a result of this review. Any adjustments in the funding charge would still be limited to the \$100 indexed cap.

While the premium is exposure-related, the proposal includes surcharges that are risk-related. Our evidence indicates that failure to make required contributions is an excellent indicator of risk that does not require an independent analysis of financial condition. By failing to make required contributions, an employer declares that a plan represents a significant risk to the program. The surcharges contained in the proposal would not be limited to the \$100 indexed cap.

A surcharge would apply to plans that fail to satisfy the minimum funding standards in the future without obtaining a waiver or extension of the amortization period. This surcharge would be 50 percent of the funding charge for each missed contribution, and would remain at 50 percent for 5 years unless the missed contribution is made sooner.

A plan that receives a funding waiver or an extension in the future would also pay a surcharge. This surcharge would be 50 percent of the funding charge if the waiver is 1 year old, 40 percent if it is 2 years old, and so on, down to 10 percent. If the waived amounts were paid, the surcharge would cease. These surcharges apply to situations in which employers are granted waivers and also to those in which a waiver may be pending or may not have even been requested.

The funding surcharge would be doubled for plans that have unfunded vested liabilities and also have large contingent obligations that are related to plant shutdowns and similar situations. These types of benefits are very troublesome to the PBGC because they are typically very large and can be triggered virtually overnight, which makes sound funding of them very, very difficult.

This surcharge on waived or missed contributions is included in our proposal for the simple reason that an employer that does not make required contributions is in effect taking out a loan from the pension plan. Employers who do not make required contributions are turning to their pension plans and the benefits that they have promised to their employees for low-cost, virtually free, financing. The effect of these surcharges is to increase the cost of that financing, to place it on a more equal footing with other types of credit, such as commercial loans, so that participants' benefits are less likely to be jeopardized when a troubled company evaluates financing alternatives.

Finally, the proposal would make the employer and its control group liable for premiums. Under current law, premiums are liabilities of the plan, not the employer. Thus, increased premiums simply increase plan underfunding, and at termination, may result in benefit losses to participants. Because responsibility for plan funding ultimately lies with the control group that maintains the plan, responsibility for payment of premiums should also fall on the controlled group.

The administration believes that this proposal meets several critical criteria. First, it will raise the additional revenue needed by the PBGC. We estimate that the proposed premium structure will produce about \$750 million in single-employer premium receipts in fiscal year 1988, \$470 million more than the current flat rate would yield, and that premium receipts will increase to about \$900 million, \$610 million more than under current law, in fiscal year 1989, the first full year that the new rates will be in effect. These estimates may change based on the distribution and degree of underfunding that actually exists in those years.

Second, the proposal will be simple to implement. The PBGC will not need significant additional resources, and there will be little additional paperwork burden on employers and plan administrators because premium calculations will be based on data that are already compiled and reported by plans. Small plans will have no added paperwork burden.

Third, the proposal's automatic adjustment mechanism will reduce the funding charge when experience is more favorable than anticipated and increase it, within specified limits, when experience is worse than anticipated.

As you know, my predecessors and I have testified before Congress virtually every year for the last 6 years about our ever-growing revenue needs. The mechanism that we were talking about will help reduce the need for these annual appeals for revenue in the future by providing for adjustments in the premium that will enable the PBGC to deal with changes in our claims experience. If we were requesting an increase in the premium today without an adjustment mechanism, we would have to ask for a higher average premium in order to ensure that the premium could cover the possibility of one or more large future claims in the near future.

Fourth, the proposal will equitably allocate premium charges. Only those plans that present a significant risk to the insurance program will pay the funding charges and surcharges. Well-funded plans—the ones that represent little risk to the program—will pay a lower premium.

Finally, the premium for employers that maintain less-well-funded plans will not be unreasonable. The maximum premium for a plan that meets its minimum funding obligations would be \$100 per participant. This is about one-third of 1 percent of the total compensation of an employee in the manufacturing sector in 1985—less than most companies pay in a year for life insurance, workers' compensation, or unemployment insurance on an employee's behalf, and less than a typical monthly health insurance premium. In a sample of 38 Fortune 500 companies that have defined benefit plans, the average pension contribution was over \$2,200 per employee in 1982. The maximum premium we are proposing is less

than 5 percent of that amount. Since many of the employers that are liable for the maximum premium have plans that are underfunded by more than \$15,000 per participant, we believe the premium is very reasonable for the protection that it provides.

In conclusion, let me say that a variable-rate premium will be a major step toward restoring the health of the PBGC's single-employer pension insurance program without adverse effects on soundly funded defined benefit plans. Changing the premium structure will not, however, be the panacea that solves all of PBGC's problems, as the chairman pointed out earlier.

Long-term structural reforms are also needed if the PBGC is to avoid the kinds of losses that we have recently experienced. In particular, ERISA's minimum funding standards need to be changed to prevent employers from maintaining plans that are grossly underfunded, minimizing their contributions, and then escaping responsibility for fulfilling their pension promises.

The administration has submitted a separate legislative proposal that will improve the funding status of severely underfunded plans and reduce the likelihood that plans become severely underfunded in the future. The PBGC has recently been forced to assume responsibility for several large plans that had virtually no assets, yet they were in complete compliance with the minimum funding standards. That experience clearly demonstrates that the minimum funding standards need to be changed.

The administration's funding proposal also would improve benefit security by setting more realistic standards for granting funding waivers.

The variable-rate premium proposal that we are considering today is urgently needed. We look forward to working with you in considering this proposal and finding a way to make the future secure for the plans and participants covered by the PBGC's single-employer program.

Thank you very much, Mr. Chairman. I would be happy to answer any of your questions.

[Oral testimony continues on page 115. Attachments to the statement follow:]



Report and recommendations on
Single-Employer Pension Plan
Termination Insurance Premiums
required by the Single-Employer
Pension Plan Amendments Act of 1986

Promises At Risk

PENSION BENEFIT GUARANTY CORPORATION

April 1987

SEPPAA PREMIUM STUDY REPORT

A Report Requested by the
Congress of the United States
Submitted by the
Pension Benefit Guaranty Corporation
Pursuant to Provisions of the
Single-Employer Pension Plan Amendments Act of 1986

April 7, 1987

Washington : 1987

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Foreword

The Pension Benefit Guaranty Corporation is heading for serious financial trouble. Unless the Congress acts to reverse the Corporation's rapidly rising deficit, financial collapse of the Corporation is a certainty.

Since I became Executive Director -- just 19 months ago -- the Corporation's deficit has increased more than eightfold, from \$462 million at the end of fiscal year 1984 to \$3.8 billion at the end of fiscal year 1986. Unfortunately, future deficits are likely to be even higher. These deficits are the direct consequence of a series of terminations of pension plans by major American companies, mostly in the steel industry. Their unfulfilled pension promises have become the PBGC's permanent responsibility.

For years, my predecessors and I have been saying that the deepening financial problems of the Corporation would have to be dealt with soon. Soon has become now.

Congress created the PBGC to protect the retirement income of the 38 million American workers and their families who are now covered by the program. Very few people expected the program to be big or costly. But the advent of the PBGC changed incentives, and some companies responded by dumping their unfunded or underfunded pension plans on the Corporation. The PBGC's valuable and necessary insurance function began to be overwhelmed by its role as a dispenser of subsidies and a redistributor of corporate wealth.

Under current law, a company with an underfunded pension plan can continue to make pension promises to its employees, even if it has no hope of ever paying for those promises. If pension insurance did not exist, a troubled firm's underfunded pension promises would be worthless. But PBGC backing transforms an underfunded pension plan into something almost as valuable as a well-funded plan. Thus, the current rules allow a few companies to finance their employee retirement expense using somebody else's money.

So long as the PBGC insurance program has these characteristics, claims against it will be uncontrollable. Uncontrollable claims will lead to uncontrollable premiums. When this happens, responsible companies may not willingly continue to underwrite irresponsible companies' pension promises. At some point, those companies may decide that their premium dollars can

be better used elsewhere. They may replace their defined benefit plans with other arrangements. When companies with well-funded plans terminate their plans, the premium burden will rest on fewer and fewer shoulders, inducing the remaining companies with well-funded plans to "rush to the door." That would end any semblance of a sound financial base for the PBGC.

The Administration believes that the best solution to this situation is to redesign the basic machinery of the PBGC program to change the incentives that currently influence the behavior of plan sponsors. A key change is to introduce a type of risk-rating that we have called a variable-rate premium. Specifically, the PBGC proposes a new premium structure that is simple to understand and administer, ensures that plans that present the greatest risk pay the highest premiums, avoids unreasonable transition burdens, generates revenue adequate for the program's needs, and allows for automatic adjustment of premiums to reflect future needs.

The variable-rate premium is an important step in the right direction. But it alone will not cure the PBGC's problems. The Administration has also proposed changes in the minimum funding standards. The PBGC's current experience, which has included the termination of several large plans with virtually no assets, demonstrates why the minimum funding standards must be changed.

The 99th Congress was aware of the problems of the PBGC, and enacted an increase in the premium and several reforms in program operation. But the premium increase was not sufficient to support the very large pension plan terminations that have taken place recently. And the reforms were not sufficient to protect the program from large terminations and escalating deficits of the future.

The 99th Congress also required the PBGC to undertake the study that is reported in this publication. The PBGC has explored many options. The Corporation believes that in this Report it recommends a workable answer to the challenge: How employers, employees, and the Federal Government working together can ensure that the legitimate retirement expectations of millions of American workers are fulfilled.

Kathleen P. Utgoff
Executive Director

Washington, D.C.
April 1987

Executive Summary

Congress established the Pension Benefit Guaranty Corporation (PBGC) in 1974 under Title IV of the Employee Retirement Income Security Act (ERISA) to protect workers' pension benefits when private pension trusts terminated without sufficient assets to meet their commitments. The mechanism for carrying out this purpose was an insurance program funded through premiums paid by covered defined benefit pension plans.¹

The evidence available in 1974 suggested that the PBGC would be a modest operation; there was no reason to expect that it would need revenue substantially in excess of that provided by the initial premium of \$1.00 per participant per year.

It soon became evident that these expectations were optimistic. In 1977, the PBGC found it necessary to ask that the premium be more than doubled. Congress raised it to \$2.60 per participant, effective January 1, 1978. By 1982, \$2.60 had proven inadequate and the PBGC requested another increase. After a 4-year delay, Congress acted on this request and fixed the premium at \$8.50 per participant, effective January 1, 1986. By then however, it was already clear that \$8.50 was not enough.

In legislation enacting the 1986 premium increase, Congress directed the PBGC to study several issues relating to its premium structure, its methods of forecasting revenue needs, and the impact on its operations of the program reforms that accompanied the new premium.²

The PBGC has now completed this study. Its principal conclusions are:

1. In its present form, the single-employer insurance program rewards troubled firms for draining assets from their pension plans, thus rendering the costs of the program essentially uncontrollable.
2. The program reforms enacted in 1986 forestalled some potential problems but did not eliminate the perverse incentives that currently exist.
3. No method has been found for predicting the program's revenue needs with a useful degree of accuracy.

4. The program's current premium structure, under which all plans, regardless of financial condition, are assessed the same per capita amount, no longer raises revenue in an equitable and economically efficient fashion. Premiums paid by plans should be rationally related to the actual and potential costs that they impose on the program; this approach would minimize the subsidies that are implicit in the current structure, encourage sounder pension funding, and reduce the risk that the premiums charged to soundly funded plans could rise to levels that would discourage their continuation.

On the basis of these findings, the PBGC recommends that:

1. Premiums for the single-employer pension insurance program be assessed on a basis that relates premiums to costs;
2. Premiums be set at a level that can reasonably be anticipated to amortize in real terms the program's current deficit over a period of no more than 30 years and fully fund future claims as they are incurred; and
3. The Congress establish a system for adjusting premium schedules automatically, within specified limits, to reflect the program's experience.

Introduction

Chapter I of this report describes the single-employer pension insurance program's structure, operations, and financial history. As of September 30, 1986, the program's deficit was \$3.8 billion. Although most of the deficit is attributable to losses incurred in the past 2 fiscal years, the program has lost money in 10 of its 12 years of operation. Claims have almost always exceeded forecasts. The main reasons for the steady decline in its financial condition are the following:

1. Firms that are in financial trouble and have seriously underfunded pension plans can make credible pension promises at little cost to their equityholders, because the PBGC will stand behind their unfunded benefits. This feature of the program permits poorly funded plans to remain poorly funded.
2. ERISA's minimum funding standards are based on traditional actuarial funding principles, the goal of which is to allocate pension costs among generations of shareholders and employees. The standards do not necessarily ensure that a particular plan will be fully funded for promised benefits at every point in time. In addition, employers can obtain waivers of the minimum

funding requirements under conditions where the waiver may not be commercially reasonable.

3. When a plan terminates with a claim against the PBGC, the plan sponsor is almost always in bankruptcy proceedings. Although the law gives the PBGC the right to recover the plan asset insufficiency from the sponsor, this claim is severely limited, both in amount and in its priority in bankruptcy proceedings.

4. Large defined benefit plans are concentrated in manufacturing industries, some of which have suffered declines over the past few years and have generated large claims against the PBGC insurance program.

5. Increases in the PBGC's premiums, which must be approved by Congress, tend to lag behind the recognition of the need for more funds.

If these problems are not overcome, the single-employer insurance program will almost certainly continue to encounter financial difficulties and will eventually become illiquid. This Report offers proposals for dealing with the most serious of these problems. The alternatives to finding remedies are not attractive: conversion of the insurance program into an explicit subsidy scheme, steadily rising premiums to prevent immediate insolvency, or indecision leading in the long run to the need for painful and costly actions.

The Effect of SEPPAA on the Corporation

Chapter II discusses the effect on the PBGC of program reforms included in SEPPAA. The most important of these legal changes was the rule that an underfunded plan may be terminated voluntarily only if its sponsor can meet statutory standards of "distress." After SEPPAA, ongoing firms will generally not be able voluntarily to terminate their plans when their net worth (and hence the PBGC's claim for employer liability) is low. Most of the largest claims incurred in the past, however, would have met the new law's distress criteria.

SEPPAA created an additional employer liability claim for the PBGC in cases where the sponsor of a terminated, insufficient plan has little or no net worth. The new claim may increase the PBGC's recovery in some cases, but it has a low status in bankruptcy, is subject to mandatory extended payment terms, and generally does not cover the entire insurance loss.

SEPPAA reduced the potential for future claims from relatively healthy firms. This effort of SEPPAA is of substantial importance, because it forecloses a potentially major source of claims against the PBGC program. Moreover, SEPPAA accomplished

this result before any problem with relatively healthy firms arose.

SEPPAA did not address the central issues discussed in this Report. It did not deal with the principal causes of the PBGC's financial deterioration -- the incentives that have made pension underfunding advantageous for some employers. It did not alter the PBGC's claims in bankruptcy. Also beyond the new law's scope were the weaknesses of the current minimum funding standards and the cumbersome procedures for adjusting premiums.

Forecasting the PBGC's Premium Needs

Chapter III explains how the PBGC forecasts its premium needs, and considers methods that might produce more accurate results.

A large number of factors are pertinent to the PBGC's future revenue requirements. The most important and least predictable of these is the amount of net claims against the insurance program. Other factors include future administrative expenses, experience gains or losses, and changes in the program's premium base.

Various studies that attempt to correlate net claims economic variables have not produced useful results. The reason for this failure is that the bulk of the PBGC's liability arises from a very small number of "catastrophic" events. It is doubtful that any methodology can produce useful forecasts of net claims; therefore, the insurance program's revenue needs will never be foreseeable with acceptable precision. The PBGC now proposes that the Congress establish a mechanism for automatically adjusting premiums in response to changes in claims experience, thereby preventing the accumulation of large deficits or surpluses.

Recommendations to the Congress

The PBGC concludes in Chapter IV that its current flat-rate per capita premium is a major cause of the insurance program's deepening financial problems and should be replaced by a structure that reflects the funded status of covered plans. The PBGC recommends that the Congress enact machinery to enable the Corporation to charge a type of risk-related premium called a variable-rate premium.

The PBGC's reasons for recommending a variable-rate premium include the following:

- o Relating premiums to underfunding reduces the subsidies that are implicit in the flat-rate premium structure. A flat-rate premium is a form of transfer program, under which sponsors of less risky defined benefit plans subsidize sponsors of riskier plans. Critics of this

mechanism contend that it diverts premium dollars from more successful (and presumably more productive) firms to less successful firms. It also penalizes sponsors of less risky plans, thus discouraging them from maintaining PBGC-insured plans.

- o A variable-rate premium encourages all sponsors -- even prosperous ones -- to maintain higher funding levels.
- o A variable-rate premium is more equitable.

The PBGC has identified criteria for a new premium structure that would improve the current system and meet the program's needs in the future:

1. Simplicity. The new structure should be readily understood by plan administrators and should be enforceable by the PBGC without any major expansion of resources.
2. Equitable allocation of premium charges. Plans that present the greatest risk and exposure to the PBGC's insurance program should pay the highest premiums.
3. Avoidance of unreasonable burdens. A limitation should be placed on the immediate increase in premium costs.
4. Adequate revenue for the program's needs. The new premium should raise enough revenue to cover anticipated claims and retire the program's existing deficit over a reasonable period of time.
5. Automatic adjustment of premiums to reflect future needs. An automatic adjustment mechanism should be instituted to keep the program's revenues in line with its needs and avoid the buildup of new deficits in the future.

The PBGC has developed a proposed premium structure that satisfies the criteria set forth above. This proposal includes:

* A flat per-participant charge, equal to the current rate, indexed to increases in wages, to be paid by all plans;

* An additional "funding charge" based on the difference between a specified "funding target" and the value of plan assets, to be paid by all plans with 100 or more participants that do not have sufficient assets to meet the funding target;

* A "cap" on how much any plan would pay per participant, which would be phased out over a long period;

* An additional charge for plans that had recently obtained minimum funding waivers or failed to meet minimum contribution requirements;

* Automatic adjustment of the funding charge, at specified intervals, to reflect differences between the insurance program's actual and projected financial condition; and

* Imposition of the liability for premium payment on the plan sponsor and the other members of its controlled group.

The PBGC's current estimate is that the proposed premium structure would have produced approximately \$775 million total revenue in 1986, had it been fully effective. The estimate is sensitive to the distribution and degree of underfunding in plans that actually exist in each year. The PBGC estimates that revenues from this structure will be sufficient, over the next 30 years, to fund new net claims of just over \$600 million per year (in constant 1987 dollars) and to eliminate the PBGC's \$3.8 billion deficit.

Details of the proposal are presented in Chapter IV.

NOTES

¹ In 1980, a separate insurance program was established for multiemployer pension plans (i.e., collectively bargained plans covering employees of two or more unrelated companies). This program replaced an interim program that had been in place since 1974. This Report deals only with the program for non-multiemployer plans.

² Title XI, Consolidated Omnibus Budget Reconciliation Act of 1985 (1986), §11017. Title XI's short title is the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA).

Chapter I

INTRODUCTION

"As soon as practicable after the date of the enactment of this Act, the Pension Benefit Guaranty Corporation shall conduct a study of the premiums established under the single-employer pension plan termination insurance program...."

SEPPAA, Section 11017(a)(1)

The Pension Insurance Program

Congress established the Pension Benefit Guaranty Corporation (PBGC) as one of the pension reforms enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Congress created the PBGC to protect the pensions of workers in defined benefit pension plans that terminated without adequate assets to pay promised benefits.

A number of pension plans had terminated without adequate assets. The most striking example stemmed from the bankruptcy of the Studebaker Corporation in 1964 and the termination of its pension plan.¹ The plan was underfunded, and some participants lost a large portion (some up to 85 percent) of their vested benefits. The PBGC was established to prevent such losses, not by repaying them with tax revenues but by operating a self-financing insurance program.

The PBGC Pension Insurance Program

The PBGC operates two separate and distinct insurance programs. One covers single-employer pension plans and the other covers collectively bargained pension plans to which two or more unrelated employers contribute. Both programs cover defined benefit pension plans (plans under which a participant's benefit at retirement is based on a formula that normally takes into account length of service, compensation, and other factors). The single-employer program covers approximately 110,000 plans with 30 million plan participants and beneficiaries. It excludes individual account plans²; plans sponsored by governmental units, churches, or other ERISA-exempt entities; and small plans (fewer than 25 participants) sponsored by professional corporations.

This Report examines only the problems of single-employer pension plans. It does not address multiemployer pension plans, and its recommendations³ do not apply to the multiemployer pension plan insurance program.

Each covered plan pays the PBGC an annual premium of \$8.50 per participant. Plans with 500 or more participants must make estimated payments no later than 2 months after the beginning of each plan year; smaller plans' premiums are due 7 months after the beginning of the year. The failure of a plan to pay premiums does not affect the participants' right to PBGC guarantees upon plan termination.

Congress sets the PBGC's premium rates. Congress set the premium initially at \$1.00 per participant, then increased it to \$2.60 per participant, effective January 1, 1978, and to \$8.50 per participant, effective January 1, 1986.

The law requires sponsors of defined benefit pension plans to make contributions to their plans in accordance with minimum funding standards set forth in ERISA and the Internal Revenue Code. Required contributions must be made (or waivers must be obtained from the Internal Revenue Service) every year until the plan is terminated under procedures set forth in Title IV of ERISA. A plan can terminate in three ways:

1. Standard. If the plan's assets are sufficient to provide all of its "benefit commitments" (a term defined in ERISA to include essentially all vested accrued benefits), the plan may be voluntarily terminated in a "standard termination." The plan administrator must notify participants and the PBGC of the termination but need not obtain any governmental or other approvals. The assets of the plan must be used to purchase annuity contracts from a licensed insurance company, and the insurer must make an irrevocable commitment to provide all of the plan's benefit commitments (plus any other plan benefits that can be purchased with the available funds).

2. Distress. If the plan's assets are not sufficient to fulfill all benefit commitments, the plan may be voluntarily terminated only in a "distress termination." A plan is eligible for distress termination if the employer that maintains it can satisfy at least one of four statutory distress criteria. Two of these tests are objective: the employer must either be in bankruptcy liquidation or in reorganization under the Bankruptcy Act. In the latter case, distress termination requires the approval of the bankruptcy court. The other two tests are more subjective -- inability to continue in business if the plan is not terminated and unreasonably burdensome pension costs due solely to a workforce decline -- and require PBGC approval of the termination.

3. Involuntary. The PBGC may initiate action to terminate a plan involuntarily if the plan is unable to pay benefits when due, the sponsor has failed to satisfy the minimum funding requirements, or certain other conditions exist. Involuntary termination requires court approval.

Following a distress or an involuntary termination, the PBGC normally becomes trustee of the terminated plan and determines whether the plan has sufficient assets to provide guaranteed benefits. The PBGC makes this determination by valuing benefits on the basis of its own actuarial assumptions, which reflect prices in the annuity market.⁶ As trustee, the PBGC invests the plan's assets and becomes responsible for paying both guaranteed benefits and any nonguaranteed benefits that were funded when the plan terminated.

Guaranteed benefits are those that were vested or in pay status prior to plan termination and that do not exceed certain limitations. The most important limitations are:

1. Increases. Benefit increases resulting from a plan or plan amendment adopted within 5 years preceding termination may not be fully guaranteed. In general, 20 percent of an increase is guaranteed after 1 year, and an additional 20 percent becomes guaranteed each year thereafter. (If the increase is less than \$100.00 per month, it becomes guaranteed at the rate of \$20.00 per month for each full year for which it was in effect before termination.)

2. Supplements. If the monthly payment that an early retiree receives under the plan exceeds the monthly payment to which he would have been entitled if he had delayed his retirement until the plan's normal retirement age, the excess portion of the payment is not guaranteed. (For example, if a participant whose benefit would be \$500 per month at the plan's normal retirement age of 65 retires instead at age 60 and begins receiving \$600 per month -- a \$400 early retirement benefit plus a \$200 early retirement supplement -- the PBGC guarantees only \$500 per month.)

3. Cap. A dollar ceiling, which is indexed to the "old law" Social Security taxable wage base (calculated without regard for the 1977 Social Security Act amendments), caps guaranteed benefits. For 1987, this ceiling is \$1,857.95 per month. (If the participant begins receiving benefits before age 65 or in a form other than a life annuity, this limit is actuarially adjusted.)

In addition to guaranteed benefits, participants receive any nonguaranteed pension benefits that are funded by plan assets. Whether benefits are funded is determined in accordance with Section 4044 of ERISA, which describes the order in which plan assets are allocated to benefits.

PBGC Funds

To carry out its financial responsibilities, the PBGC maintains a "revolving fund," consisting of premium collections and various miscellaneous revenues, and a "trust fund," consisting of the assets of trustee plans. The PBGC invests the revolving fund in U.S. Government securities and the trust fund in a diversified portfolio consisting primarily of stocks, bonds, and real estate. Responsibility for benefit payments is divided between the two funds; the trust fund's share equals the current average funded percentage of all PBGC-trustee plans. (Payments are normally made by the revolving fund, which is then reimbursed by the trust fund.)

In addition to its revolving and trust fund assets, the PBGC has by statute a \$100-million line of credit with the U.S. Treasury, which it has used only once, to provide \$100,000 for startup expenses in 1974.

A plan that terminates without sufficient assets to finance PBGC-guaranteed benefits gives rise to a claim against the insurance program. The company that maintained the plan (along with all other companies in the same group of commonly controlled trades and businesses) is liable to the PBGC for the difference between the value of the PBGC-guaranteed benefits and the value of the assets available to fund those benefits. The employer's liability is limited, however, to the greater of 30 percent of the controlled group's net worth or 75 percent of the amount of the asset insufficiency. In addition, the employer is liable to the plan for any due and unpaid contributions. To the extent that these are collected, they reduce the PBGC's loss (and may also fund nonguaranteed benefits).

If the employer is in bankruptcy proceedings (as it usually is), part of the PBGC's claim (the portion that does not exceed 30 percent of the controlled group's net worth) has the priority status of a Federal tax lien. The remainder of the claim normally has unsecured general creditor status and is subject to mandatory extended payment terms. The status of the plan's claim for due and unpaid contributions varies. Recovery on employer liability claims, including claims for unpaid contributions, have averaged about 8 cents on the dollar.

The Financial Condition of the PBGC

Table I-1 shows the results of the single-employer insurance program's operations over its 12-year history. In 10 of those years, the program lost money. In the past 2 years, the PBGC has lost \$3.4 billion and experienced an eightfold rise in its deficit. The recent losses are primarily attributable to a handful of terminated plans, most notably those of LTV Corporation, Wheeling-Pittsburgh Steel Corporation, and Allis-Chalmers Corporation.

The PBGC expects to make benefit payments in fiscal year 1987 estimated at \$592 million and in fiscal year 1988 at \$817 million. To meet these commitments, the PBGC will draw on two revenue sources. First, investment of its assets will generate about \$243 million (fiscal year 1988). The second source is premium payments, which will amount to about \$285 million in each of the next two fiscal years (assuming no change in the \$8.50 per capita premium).

Thus, the PBGC expects benefit payments to exceed premium collections and investment income by about \$145 million in fiscal year 1987 and by about \$291 million in fiscal year 1988. The program's condition could deteriorate even more rapidly if other large companies terminate their underfunded pension plans.

The Causes of the PBGC's Deficit

The financial condition of the PBGC has steadily worsened for two principal reasons. First, the system as designed contains weaknesses. Second, those weaknesses have been aggravated by unanticipated structural changes in the economy. This Report concentrates on the need to strengthen the design of the PBGC system.

Table I-1

PBGC Claims Experience by Fiscal Year
(Dollars in millions)

Date of Termination	Number of Plans	Guaranteed Benefit Liability	Plan Assets	Employer* Liability	Net Claims
7/1/74 - 6/30/75	98	\$ 56	\$ 19	\$ 7	\$ 30
7/1/75 - 9/30/76	172	88	44	26	18
10/1/76 - 9/30/77	130	52	21	7	23
10/1/77 - 9/30/78	101	125	46	7	73
10/1/78 - 9/30/79	80	81	32	4	45
10/1/79 - 9/30/80	104	166	77	5	85
10/1/80 - 9/30/81	134	176	76	27	73
10/1/81 - 9/30/82	127	443	174	7	263
10/1/82 - 9/30/83	131	416	219	14	183
10/1/83 - 9/30/84	88	60	24	0	35
10/1/84 - 9/30/85	77	254	75	2	177
10/1/85 - 9/30/86	73	1,139	248	141	750
Total	1,315	\$3,056	\$1,056	\$246	\$1,755
Pending	30	4,038	1,851	42	2,145
Total	1,345	\$7,094	\$2,906	\$288	\$3,900

* After deductions for uncollectibility of employer liability.

Note: Detail may not add up to total because of rounding.

Source: PBGC 1986 Annual Report data.

The principal weaknesses of the system can be summarized as follows:

1. Penalties. Employers pay little or no penalty for making pension promises that they cannot afford to keep. Workers believe these promises, because they know that PBGC guarantees typically cover 85 to 90 percent of vested benefits. Yet a company's failure to fund its pension plan does not lead to higher PBGC premiums. This discrepancy between benefits and costs helps to explain why claims against the insurance program have increased beyond the levels that were originally forecast.

2. Funded status. The current minimum funding standards do not ensure that all plans will make progress toward full funding. Although pension plans in general have become better funded since the enactment of ERISA, the weakest plans -- those most likely to result in claims -- have not improved their funded status. Indeed, during the past 2 years, newly terminated plans have been worse funded, on average, than those that terminated previously.

3. Bankruptcy status. Limitations on the priority status of PBGC claims in bankruptcy prevent recovery of any significant portion of employer liability.

4. Delays. The PBGC's last request for a premium increase was not approved by Congress until 4 years later, resulting in a loss of more than \$500 million in premiums and investment income. Machinery that requires action by Congress every time a premium change is needed may result in a long lag between the time the need for the change arises and the time the change becomes law. An improvement in this machinery would allow the Corporation to adjust premium rates based on actual experience.

NOTES

¹ The Studebaker-UAW Pension Plan became effective on November 1, 1950, and terminated on November 1, 1964. Of the 10,437 employees covered by the plan, 3,457 persons over the age of 60 received full benefits (annuities cost \$21.6 million); 4,080 workers age 40 to 60 received 15 percent of accrued benefits (a lump sum payout of \$2.4 million); and 2,900 workers below the age of 40 or with service of fewer than 10 years (nonvested) received nothing. Vested benefits at the time of termination had an estimated value of \$37.9 million; plan assets were sufficient to cover 63.4 percent of that value.

² An individual account plan is one under which contributions are made to an account for each participant, and his benefit amounts to whatever is in the account when he becomes eligible to receive benefits. Common examples are profit sharing plans, employee stock ownership plans, "money purchase" and "target benefit" pension plans, thrift and savings plans, and cash-or-deferred (Section 401(k)) plans. A plan that is not an individual account plan is, by definition, a "defined benefit plan."

³ For a discussion of the multiemployer program's condition, see Pension Benefit Guaranty Corporation, Corporate Policy and Regulations Department, Multiemployer Premium Study Required By the Employee Retirement Income Security Act of 1974, As Amended (September 1985). This program is in better financial condition than its single-employer counterpart, having a balance sheet surplus and little prospect of deterioration in the immediate future. Income generated by the multiemployer program (currently about \$20 million per year) cannot be law be applied to the single-employer program.

⁴ Benefits of de minimis value can be commuted to their present value and distributed to participants as lump sums. Other alternatives to insurance company annuities are permissible if the participant consents.

⁵ If the employer is part of a group of trades or businesses under common control, every "substantial member" of the controlled group must satisfy one of the distress criteria before any plan maintained by any member of the group can qualify for distress termination. The controlled group members need not all satisfy the same criterion.

⁶ The PBGC has not heretofore purchased annuities to close out plans for which it is the trustee, even where the assets were sufficient to provide all guaranteed benefits.

Chapter II

THE EFFECT OF SEPPAA ON THE CORPORATION

"The Corporation shall specifically consider...the effects of the amendments made by this title on the long-term stability of the single-employer pension plan termination insurance program...."

SEPPAA, Section 11017(a)(2)(A)

Because only a year has passed since the enactment of SEPPAA, data on post-SEPPAA terminations are too limited to support inferences about the long-term effect of the new law on the PBGC's financial condition. It took much longer than a year for the long-term effects of ERISA to become evident. In the absence of more extensive experience, this chapter examines the pertinent provisions of SEPPAA, especially those offering the most potential to curtail abuses of and check the growth of net claims against the program, and describes their likely effects on the insurance program.

Prior Law

Prior to SEPPAA, an employer could terminate an underfunded plan at any time, and the PBGC in most cases had little choice but to become trustee of the plan and assume responsibility for paying guaranteed benefits. The employer was liable to the PBGC for the difference between the plan's assets and liabilities, but this liability was limited to 30 percent of the employer's net worth. This limitation created an incentive for an employer that was continuing in business to terminate its underfunded plans at a time when its net worth was low. While few employers actually took advantage of the "PBGC put," the potential for large claims attributable to plans of relatively healthy firms troubled the PBGC.

The insurance program also suffered substantial losses attributable to waivers of ERISA's minimum funding standards in circumstances where the likelihood of employer recovery was low or non-existent. A limited PBGC staff study conducted in 1983 attributed about 20 percent of the insurance program's then-existing deficit to plans terminated by employers that obtained minimum funding waivers and then went bankrupt within a very few years.

Despite its direct financial interest in waivers, prior to SEPPAA the PBGC had no formal role in deciding whether they should be granted. The Internal Revenue Service (IRS) had jurisdiction over funding waivers and administered the process of granting

waivers. Under SEPPAA, the IRS must notify the PBGC of large waiver requests and allow the Corporation to comment. Formerly, notification to the PBGC was discretionary.

Transfers of poorly funded plans to weaker employers that could not continue contributions represented a third category of potential "abuses" under prior law. In 1981, the PBGC brought suit against International Harvester Corp. (now Navistar International) as a result of Harvester's sale of its Wisconsin Steel Works subsidiary to a financially weak buyer. Wisconsin Steel's underfunded pension plans terminated within 3 years after the sale with unfunded guaranteed benefits of more than \$60 million. In this suit (which has yet to be adjudicated), the PBGC argued that a company could not escape financial responsibility for its pension plans by transferring sponsorship to a third party that clearly lacked the resources to continue them. Harvester countered with the argument that, regardless of their effect on the PBGC, such transactions were not forbidden by law.

Premium Increase

SEPPAA increased the single-employer premium from \$2.60 to \$8.50 per participant for plan years beginning on or after January 1, 1986. Even before this increase, the PBGC informed Congress that, because of the Allis-Chalmers and Wheeling-Pittsburgh terminations, the revenue generated by the \$8.50 premium would not be enough to amortize the insurance program's deficit and also pay anticipated future claims. The PBGC estimated that, after the premium increase took effect, its deficit would grow at a rate of at least \$100 million a year. The termination of the plans of LTV Corporation's steelmaking divisions rendered this estimate obsolete. Even if LTV were the last claim that the insurance program ever incurred, the PBGC's current revenue and assets would be insufficient to pay guaranteed benefits in plans that have already terminated.

Distress Termination

SEPPAA permits an employer to terminate an insufficient plan voluntarily and make a claim against the insurance program only if the contributing sponsor and all substantial members of its controlled group meet one of four statutory distress tests: (1) be in bankruptcy liquidation; (2) be in bankruptcy reorganization with court approval of the termination; (3) be unable to pay debts when due or to continue in business without a plan termination; or (4) face unreasonably burdensome pension costs attributable solely to a declining workforce.

SEPPAA's distress standard effectively eliminates the opportunity for healthy firms to terminate underfunded plans at times of their choosing. The change in the law does not affect the great bulk of the insurance program's losses, which result

from terminations by financially distressed employers. In the period 1983 through 1985, 57 percent of large claims against the program were attributable to bankrupt employers. Another 33 percent arose from one insolvent plan that the PBGC would have been required to terminate involuntarily if SEPPAA had then been in effect. (See Involuntary Termination, below.) Hence, SEPPAA's provisions would at best have forestalled only 10 percent of the program's net claims between 1983 and 1985. The largest subsequent terminations, those of the Wheeling-Pittsburgh and LTV plans, are also unaffected by SEPPAA's new requirements.

Employer Liability

SEPPAA increases the liability that the sponsor of a terminated plan and other members of its controlled group owe to the PBGC. The additional liability is equal to the difference, if any, between 75 percent of unfunded guaranteed benefits and 30 percent of the net worth of the controlled group. Generally, this additional claim has general unsecured creditor status in bankruptcy, and the PBGC is required to negotiate extended payment terms with the sponsor. With its low priority status in bankruptcy, and with the extended payment terms, this new claim is unlikely to produce substantially higher PBGC recoveries.

Minimum Funding Waivers

SEPPAA authorizes the Secretary of the Treasury to require security as a condition for granting a minimum funding waiver when the accumulated funding deficiency (including previously waived amounts and the amount of the waiver being sought) exceeds \$2 million and requires consultation with the PBGC on such applications. These provisions formalize powers and arrangements that existed under prior law.

Avoidance of Liability

SEPPAA specifically provides that an employer cannot avoid liability under Title IV of ERISA by entering into a transaction, the principal purpose of which is to avoid such liability. This provision makes clear that an employer cannot avoid liability by, for example, transferring pension obligations to a weaker employer. The explicit statement of this principle in the statute may help to prevent the recurrence of situations like Wisconsin Steel.

Involuntary Termination

SEPPAA requires the PBGC to initiate involuntary termination of any plan that lacks sufficient assets to make current benefit payments when due.

In September 1986, the PBGC sued to terminate LTV's Republic Steel salaried pension plan under this provision. With \$250 million in unfunded liabilities, the Republic Plan could not make its October 1986 payments of approximately \$2 million to retired participants. (The LTV plans that were involuntarily terminated in January 1987 were not insolvent; they were terminated for failing to meet ERISA's minimum funding standards.)

Unresolved Issues

Although SEPPAA addressed significant issues, others remain. This section examines two of these: minimum funding standards and bankruptcy priority.

Minimum Funding Standards

ERISA's minimum funding standards, based on traditional actuarial principles, aim to spread pension costs equitably over future generations of shareholders and employees. The standards do not ensure that every plan will be fully funded when it terminates or even that all plans will make progress toward full funding. One recent termination illustrates how a plan's funded level can deteriorate sharply even though the employer makes all required contributions.

The Allis-Chalmers United Auto Workers Pension Plan terminated on July 26, 1985, with virtually no assets on hand. At termination, the present value of the plan's liabilities exceeded the value of its assets by \$140 million, the fourth largest claim in the PBGC's history.

The plan actuary employed a middle-of-the-road actuarial method (frozen initial liability) and assumptions (e.g., 7 percent investment return) throughout the period during which the minimum funding standards were in effect. At no time did the plan sponsor request a minimum funding waiver.

The plan's problems can be traced to the fact that the minimum funding standards permit certain actuarial liabilities to be amortized over relatively long periods, even when benefits are being paid out over much shorter periods. In a plan with a large proportion of retirees, the result can be a severe cash flow drain.

On January 1, 1977, the Allis-Chalmers plan had 4,700 active participants and 6,500 retired and separated vested participants. The number of actives decreased steadily over the next few years. At plan termination, they constituted only 15 percent of the participant population (1,300 actives out of 8,500 total). Because of the large proportion of retirees, the plan's minimum funding requirement was, from 1977 on, always less than its annual benefit payments.

The depletion of the plan's assets was slowed somewhat by an agreement between the plan sponsor and the United Auto Workers that the company would contribute in excess of minimum funding requirements (but even these additions did not produce contributions in excess of benefit payments). In 1982, the union agreed to allow contributions to revert to the ERISA minimum. Because contributions had exceeded minimum requirements in earlier years, the minimum funding requirement for 1982 was zero.

After 1982, the plan's assets decreased rapidly. When the plan terminated in July 1985, it had funds on hand sufficient for only 2 months of benefit payments.

As this case demonstrates, the current minimum funding standards, even though they work well for most plans, do not prevent claims against the PBGC's insurance program from arising from the worst-funded plans and the weakest group of employers. As Figure II-1 shows, if a plan covers an aging, retiree-heavy population (a situation currently common in basic manufacturing industries where pension plans are often weakly funded), ERISA's contribution requirements do not prevent its funded level from declining sharply, nor, if funding is already low, does ERISA compel rapid improvement.

The minimum funding standards also deal inadequately with certain benefits that are inherently difficult to fund in advance. The most notable example is "shutdown benefits," which are special early retirement benefits payable when a facility closes or by mutual agreement between employer and employee. Shutdown benefits that are triggered before plan termination are guaranteed by the PBGC in the same manner as other plan benefits, but employers rarely make more than token advance contributions to finance these entitlements.

Overall, the PBGC's experience suggests that the minimum funding standards have proved inadequate for those plans that represent risks to the insurance program. For plans in PBGC trusteeship, plan assets (excluding employer liability) for each dollar of guaranteed benefits have remained relatively steady at about 41 percent. When collectible employer liability is taken into account, the picture worsens. Plan assets plus employer liability equaled 55 percent of guaranteed benefits between 1975 and 1978, 46 percent between 1979 and 1982, and 39 percent between 1983 and 1986, excluding pending claims (for which reliable estimates of employer liability collections are not available).

Bankruptcy Priority

Creditors of a troubled company normally take steps to protect their interests by obtaining security or filing liens. By the time plan termination occurs, very few company assets are usually available to pay unfunded pension benefits or to reimburse the PBGC insurance program for its losses.

Before SEPPAA, ERISA allowed the insurance program to recoup its losses from the sponsor of a terminated plan and members of its controlled group, and this claim had the same status in bankruptcy proceedings as a Federal tax lien. The value of the claim was limited to 30 percent of the responsible controlled group's net worth, which was rarely much more than zero. Not surprisingly, therefore, the PBGC's employer liability recoveries have averaged about 8 cents on the dollar.

SEPPAA kept the PBGC's priority claim status intact and added an additional claim for a portion of insurance losses in excess of 30 percent of the employer's net worth. But this claim has unsecured general creditor status in bankruptcy and hence is unlikely to add much to the PBGC's current recoveries.

Figure II-1

**Impact of Current Minimum Funding Standards
on Defined Benefit Plans With Varying Characteristics**

Figures II-1(a) and II-1(b) show the dramatically different effect of the current minimum funding standards on two "typical" defined benefit pension plans with differing characteristics. Each figure shows changes in the plan's funded ratio over a 10-year period, assuming that the plan sponsor makes all contributions required by the minimum funding standards and that the financial climate replicates the first 10 years after the passage of ERISA.

The Figure II-1(a) plan is a salary-related plan covering a mature and stable group of participants that is expected to grow over time. The plan and its demographics are typical of many large companies. For this plan, the minimum funding standards work reasonably well. Whatever its initial level of funding, the plan is likely to make significant progress toward full funding.

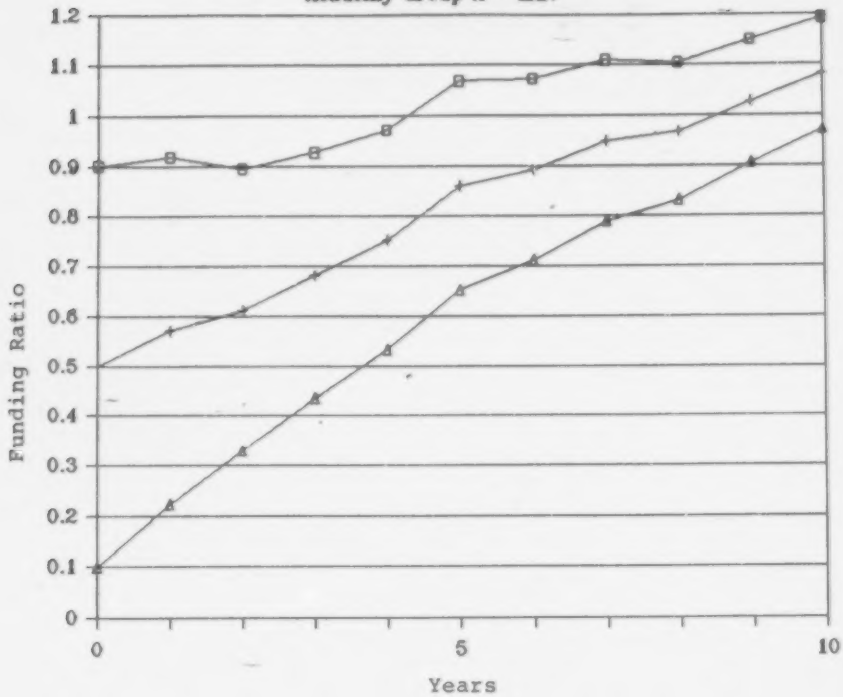
The Figure II-1(b) plan is a flat benefit plan with periodic plan amendments to bring benefit levels into line with price increases. Its participants have high average age and service, with almost half over age 50. The total size of the group is slowly declining. These characteristics are currently typical of many plans in troubled, capital-intensive industries, such as steel. The minimum funding standards do not result in any substantial improvement in this plan's funding. Moreover, if funding begins at a relatively sound level, it may decline markedly.

For a full description of the plan and participants characteristics underlying these figures, see American Academy of Actuaries, Committee on Pension Actuarial Principles and Practices, Pension Cost Method Analysis (1985).

Figure II-1(a)

AB Funded Ratio

Academy Group A - EAN

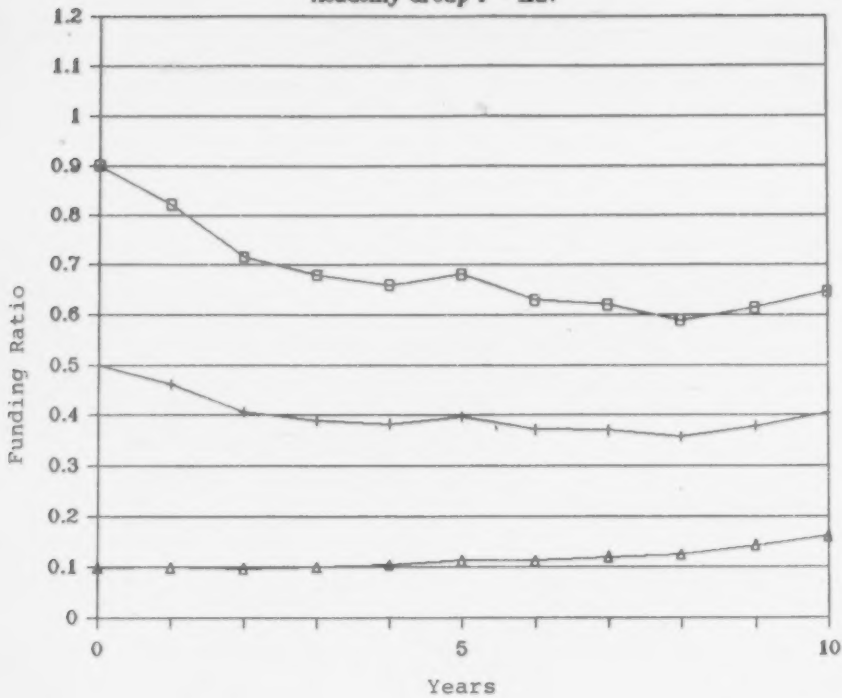


Funding ratio over time for a salary-related plan covering a mature and stable group of participants that is expected to grow, assuming three different starting or beginning ratios.

Figure II-1(b)

AB Funded Ratio

Academy Group I - EAN



Funding ratio over time for a flat benefit plan with periodic plan amendments to bring benefit levels into line with price increases, assuming three different starting or beginning ratios. Participants have high average age and service, with almost half over age 50. The total size of the group is slowly declining.

NOTES -- CHAPTER 2

¹ The Wheeling-Pittsburgh terminations occurred before the effective date of SEPPAA. The employer was in reorganization under Chapter 11 and doubtless could have obtained court approval of a distress termination. The LTV terminations, all post-SEPPAA, were involuntary, and thus the company did not have to meet the distress criteria (which it could probably have satisfied in any event).

Chapter III

FORECASTING THE PBGC'S PREMIUM NEEDS

"The Corporation shall specifically consider in its study...alternative methods of projecting...future program costs...[and] premium determinations...and alternative premium bases upon which some or all...projected future program costs would be allocated on an exposure-related or risk-related computation, which may take into account the different exposure risks imposed on the Corporation by plan sponsors with different histories and under different circumstances."

SEPPAA, Section 11017(a)(2)(D)-(G)

At the heart of the solution to the PBGC's financial problems lies reliable forecasting of premium needs. Yet the flow of claims has proven to be highly unpredictable, time and again contradicting forecasts. Additionally, as this chapter shows, the Corporation has encountered long delays in obtaining legislative authority to increase premiums; new rates have been out of date by the time they took effect.

The PBGC has tried to discover a reliable method of forecasting premium needs, exploring many different approaches. The focus of these efforts has been the forecasting of net claims by terminated plans, which is the most significant and least foreseeable pertinent factor. Despite its efforts over almost 10 years, the PBGC has yet to find any forecasting method that is both theoretically sound and feasible in practice.

This chapter begins with an examination of factors that determine the program's premium needs, then reviews the history of the PBGC's efforts to forecast those needs. It concludes with a description of the Corporation's best estimates of the range of premiums that would ensure long-term financial health for the program.

Factors that Determine Premium Needs

The PBGC's single-employer pension insurance program is intended to be self-sufficient -- financed by premiums, investment income, the assets of trustee plans, and employer liability collections. In general, to maintain the program's financial health, premiums must make up the difference between the net liabilities to participants in trustee plans and the amounts available from the program's other sources of income.

To maintain the insurance program's solvency (i.e., to equalize its assets and liabilities), the revenue needed from premiums is the amount required to balance the following equation:

$$\text{Premium Revenues} + \text{Investment Income} = \text{Net Claims} + \text{Administrative Expenses} + \text{Actuarial Charge}$$

Net claims consist of the guaranteed benefit liability less both plan assets and anticipated employer liability collections. These values are determined as of each plan's date of termination.

If the program already has a deficit, sufficient additional premium revenue (together with the additional investment earnings it will create) must be generated to retire the deficit.

To maintain the program's liquidity (i.e., to have enough assets available to pay benefits as they become due), the following equation must be balanced:

$$\text{Premium Receipts} + \text{Investment Income} + \text{Plan Assets Acquired} + \text{Employer Liability Collected} = \text{Benefit Payments} + \text{Administrative Expenses}$$

To determine the revenue needed for any particular year, the PBGC must adopt a "funding policy" -- that is, determine what portion of new claims and the existing deficit is to be retired in that year. Since its inception, the PBGC's preferred policy has been to fund all new claims as they arise and to retire the deficit (primarily caused by the unfunded portion of past claims) over 5 to 15 years. These are not the sole alternatives; Chapter IV and Appendix B discuss the merits of other funding policies.

Each of these parameters can be analyzed further, and each presents its own forecasting problems.

Administrative costs depend largely on the PBGC's staffing level, which has remained fairly constant for the past several years and is not expected to increase or decrease dramatically in the foreseeable future. Non-staff costs may be more volatile, but are generally predictable within a reasonable range. The program's administrative expenses have historically been very small in relation to annual net claims.

Premium revenues and receipts depend on the level of the premium and the size of the premium base. (Premium revenues are recognized rateably throughout the year. Premium receipts are recognized when received by the PBGC.) Under the current per capita premium structure, the program's premium base consists simply of the number of participants in covered plans, a figure that varies little from year to year. The adoption of a structure that based assessments on factors other than the number of participants would introduce additional variables, such as the

amount and distribution of unfunded pension benefits, that may be more difficult to forecast.

Investment income depends on the amount of assets available for investment and the rate of return that can be obtained. The former, in turn, depends upon beginning-of-year assets, payments of benefits and other disbursements, assets received from newly trusted plans, and collections of employer liability. The latter depends upon rates available in the capital markets and the type of assets held by the PBGC.

Plan assets are assets received from plans for which the PBGC is trustee, while employer liability collections are amounts paid by employers to satisfy the PBGC's claims against the sponsors of terminated underfunded plans. The amount and quality of these assets and collections depend upon the characteristics of plans that terminate without sufficient assets to provide PBGC-guaranteed benefits and upon the financial condition of their sponsors. The difference between these amounts and the guaranteed benefit liability assumed by the insurance program constitutes net claims -- the key element in any forecast of the program's revenue requirements.

Benefit payments resulting from the guaranteed benefit liability assumed as of a plan's date of termination are payable over many years. The specific stream of benefit payments depends on numerous factors, such as beneficiaries' annuity starting dates, forms of benefit, and mortality.

The guaranteed benefit liability associated with a particular plan is the present value of its expected benefit payment stream. The present value is determined individually for each plan, using the market interest rates in effect when the plan terminated.

The reserve for guaranteed benefits represents the present value of the program's expected benefit stream at a particular point in time. Its value is determined both by the timing of the expected benefit payments and the interest rate selected to discount this benefit stream back to the present day.

The actuarial charge or credit for a period is the change in the present value of guaranteed benefits due to the passage of time and changes in interest rates and other assumptions. If the program had no surplus or deficit and its investment return equaled the actuarial assumptions, investment income and the actuarial charge would be approximately equal. In other cases, however, the investment income and actuarial charge should not be anticipated to equal each other. For instance, if the program is not fully funded (as has generally been true for the PBGC), investment income should not be expected to equal the actuarial charge.

Although none of the preceding factors can be forecast with absolute assurance, variations in some (e.g., administrative costs) have only a minor influence on revenue needs. Net claims, by contrast, have had the largest effect, are historically volatile, and are not offset by countervailing factors. The principal reason for the PBGC's consistent underestimation of the cost of its program has been its inability to foresee the escalation of net claims.

Problems of Forecasting Net Claims

The great bulk of claims against the insurance program come from a few plan terminations. This phenomenon existed even before the recent rash of extremely large claims resulting from major steel plan terminations. From 1975 through 1983, a period when claims were minuscule by 1987 standards, 2 percent of terminations accounted for two-thirds of net claims; the proportion has since grown even more striking. (See Table III-1.) This pattern maximizes the forecaster's difficulties.

Two fundamental alternatives are available for projecting future claims. One is to project experience into the future, using either a trend line or an observed correlation with economic variables. That such a correlation exists is not a priori improbable. Even after the discovery of a statistically valid relationship, however, the PBGC's ability to forecast its net claims under the latter approach would be no better than its ability to forecast the condition of the economy.

The other option is to attempt to estimate future claims directly by identifying plans with large unfunded benefits and estimating their probability of termination. This approach is tantamount to estimating the likelihood that the sponsor will encounter serious financial hardship. For several reasons, the PBGC has never used this method to justify proposed premium changes. The practical difficulties would clearly be formidable, and the identification of a firm by a Government agency as a prime candidate of bankruptcy might become a self-fulfilling prophecy. The method was, however, examined theoretically in the study of forecasting methods that the PBGC commissioned in 1984.

Table III-1

**Distribution of Net Claims
by Size of Claim, Fiscal Years 1975-86**

Size of Net Claims	Plans		Dollars	
	Number	Percent	Millions	Percent
Greater than \$100 million	8	0.6%	\$2,636	67.6%
\$50-100 million	1	0.1	55	1.4
\$25-50 million	12	0.9	416	10.7
\$10-25 million	19	1.4	295	7.6
\$5-10 million	22	1.6	159	4.1
\$2-5 million	45	3.3	143	3.7
\$1-2 million	62	4.6	85	2.2
Less than \$1 million	1,176	87.4	111	2.8
TOTAL	1,345	100.0%	\$3,900	100.0%

Note: Detail may not add up to totals because of rounding.

Source: PBGC 1986 Annual Report data.

A more detailed understanding of the difficulties inherent in forecasting premium needs can be gained from a review of the premium forecasts that have been produced by the PBGC, with particular emphasis on the methods used to forecast net claims, and the study of forecasting methods commissioned in 1984. The record suggests that neither of the fundamental approaches to forecasting the insurance program's premium needs is likely to succeed.

The PBGC's 1977 Premium Study

When Congress established the PBGC in September 1974, it fixed the premium for the single-employer insurance program at \$1.00 per participant per year. This rate was consistent with the data presented in a study of pre-ERISA plan terminations, which concluded that in 1972 workers lost \$34 million in vested benefits as a result of terminations of underfunded defined benefit pension plans.¹ Because benefits guaranteed by the PBGC would be less than vested benefits, Congress reasonably assumed that \$1.00 per year, spread over the approximately 25 million participants then in covered plans, would meet the program's immediate needs.

The PBGC produced financial statements for its first annual report, for fiscal year 1975, on a cash basis. By the end of fiscal year 1976, it had accumulated enough information about its level of claims to be able to prepare financial statements on an accrual basis. Those statements showed that the accumulated deficit at the end of fiscal year 1975 was \$15.7 million, which rose to \$41.0 million by the end of the following fiscal year. Based on this information and the expectation that claims would not decline materially, the PBGC concluded that a \$1.00 premium would be inadequate to finance the program properly. Accordingly, it undertook its first in-depth premium study in early 1977.

The PBGC assumed that, because the primary cause of claims was the financial hardship of plan sponsors, claims experience could be related to macroeconomic variables. Toward that end, the PBGC contracted with an econometrics consulting firm to undertake a study of the insurance program's claims experience. Using data for the period from July 1, 1974, through September 30, 1976,² the study found a statistically significant relationship between the number of insufficient terminations in a calendar quarter and the unemployment rate for that quarter. The force of this discovery was weakened by the limited number of data points and by the fact that the study had to exclude one quarter's experience (the second quarter of 1976) and a large class of plans (those where the administrator alleged that the termination was motivated by the enactment of ERISA) in order to establish the relationship.

A separate analysis found that the number of participants affected by terminations was a function of the number of terminating plans, the average age of these plans, and whether the

termination was motivated by ERISA. Another analysis estimated the average value of guaranteed benefits and plan assets per participant. Collectible employer liability was assumed to be a constant percentage of the plan asset insufficiency.

Many other economic variables were tested at the same time, including the Dun and Bradstreet rate of business failures, the Federal Reserve Board index of capacity utilization in manufacturing, the ratio of gross national product to full employment output, the Dun and Bradstreet business failure series, and the Standard and Poor index of stock market prices. Except for the Federal Reserve Board index, which produced a poorer fit than the unemployment series, none of these efforts produced statistically significant correlations.

To estimate net claims for the succeeding 5 years, the relationships that had been developed were combined with the Administration's forecast of future unemployment rates. This estimate was then combined with estimates of future numbers of participants and administrative costs. It was assumed that the deficit forecast to exist on December 31, 1977, would be retired over 10 years. These calculations produced a premium level of \$2.23 per participant, which was rounded to \$2.25 when the request for an increase was submitted to Congress in September 1977.

The report submitted with the premium request explored the sensitivity of the program's premium needs to a wide variety of assumptions. Among the variations examined was the possibility that the unemployment rate would not decline in accordance with the Administration's forecast but would remain constant at 7 percent. This assumption produced a required premium of \$2.65. A straight-line projection of historical experience produced a forecast of \$2.55. In December 1977, Congress took what then appeared to be the cautious path and approved a premium increase to \$2.60 per participant, effective for plan years commencing on or after January 1, 1978.

Net claims for fiscal years 1978 and 1979 substantially exceeded those forecast by the study's most pessimistic scenario, even though the unemployment rate was below 7 percent in both years. Fiscal year 1980 was more promising: for the first time, the PBGC showed positive results of operations (a \$52 million "profit"), as net claims declined to \$26 million. In the next year, however, the downward trend resumed decisively. The program experienced \$141 million in net claims and lost \$94 million.

The 1979 Review of Net Claims Forecasting

The forecasting method used in the 1977 study appeared not only to have failed the practical test of producing the correct premium number, but further analysis also cast doubt on the relationships previously developed. An internal review, with the benefit of 3

more years of data (through September 30, 1979), failed to find a statistically valid relationship between the PBGC's claims experience and any macroeconomic variable tested.

The updated study sought correlations to both the number of terminations of insufficient plans and the number of terminations resulting in net claims against the insurance program. Also, because more data were available, the variables were lagged by periods of up to six quarters. To eliminate the possible distorting effect of the bunching of terminations in the fourth calendar quarter, a dummy variable was used for this quarter. The economic variables tested were: (1) unemployment rate; (2) index of credit rationing; (3) current liabilities of business failures; (4) capacity utilization in manufacturing; (5) manufacturing profits before taxes; (6) industrial production index; (7) gross national product, current and real; (8) corporate profits with inventory valuation adjustment and capital consumption allowance; (9) prime commercial bank rate; and (10) price index of petroleum imports.

The best relationship found was between the current liabilities of business failures lagged two quarters and the number of insufficient terminations, the R^2 of which was 0.574. (R-squared (or "fit") is the portion of variation in the termination data explained by variations in the independent variable(s). The higher the R^2 , the greater the correlation.) When this variable was tested against the number of terminations resulting in net claims, however, the R^2 declined to 0.216. Tests using multiple regressions of the economic variables did not increase the R^2 materially. Efforts to develop relationships using first differences and percentage changes in the independent variables were also unsuccessful.

The 1982 Premium Study

As a result of its 1981 claims experience, the PBGC undertook another in-depth analysis of its premium needs in January 1982. Despite the unpromising results of the 1979 review, Corporation analysts initially hoped to uncover a usable relationship between claims experience and an appropriate economic variable. The earlier impression that net claims were primarily caused by business failure had been strengthened by the finding that bankruptcy, liquidation, or other dissolution of the plan sponsor was associated with 65 percent of insufficient plan terminations, accounting for 90 percent of net claims.

The 1982 study updated the previous work with some variations. The study tried to forecast the two most significant dependent variables: total number of net claim terminations per quarter and total amount of net claims per quarter. As 28 quarters of data were now available, terminations occurring before the enactment of ERISA, regarded as possibly atypical, were

eliminated. Another change was that claims arising from the same economic event were grouped together, rather than being treated as discrete plan terminations. Analysts reasoned that a management decision to terminate several plans simultaneously (e.g., an hourly and a salaried plan) should be viewed as a single decision for the purpose of developing a predictive model.

Most of the same economic variables were tested as in the previous study. The principal variation was the use of the raw unemployment rate rather than the seasonally adjusted series. Three new variables were tested: money supply; current liabilities of business failures, \$100,000 or more per firm; and business failure rate per 10,000 enterprises. As before, lagged variables were used, this time going back as far as four quarters. Dummy variables were introduced to adjust for observed higher levels of net claims in the second and fourth calendar quarters. First differences and logarithmic transformations of the data were also explored.

The results -- as in 1979 -- were disappointing. The best relationship for forecasting the number of net claim terminations was the natural logarithm of the current liabilities of business failures (\$100,000 or more) lagged two quarters. This calculation produced an R^2 of 0.258. This variable also produced the best prediction of the total amount of net claims, with an R^2 of 0.248. In contrast, a trend line with a dummy variable for the second and fourth quarters produced an equation with a fit of 0.458.

Further analysis suggested that the third quarter of calendar 1979 was atypical. When a dummy variable was introduced for this quarter, the best predictive equation for forecasting the number of net claims increased to an R^2 of 0.373. The best relationship for forecasting total net claims was a logarithmic relationship involving only a trend line with a dummy variable for the third quarter of 1979 and a separate dummy variable for every second and fourth quarter. This calculation produced an R^2 of 0.622. Because of the logarithmic relationship, this equation produced an expected claims growth rate of 32 percent, which translated to a required premium for the period 1983 through 1986 of \$9.00 per participant. From the perspective of early 1982, this forecast seemed unreasonably high and was therefore rejected.

Two other methods of forecasting claims were also explored. A logarithmic conversion of the data distributed potential claims in a way that allowed for claims larger than any incurred to date. This approach was more important at that time, because no claims of more than \$60 million had yet been incurred. It was not developed in detail, however, owing to its technical complexity. Time series forecasting was also explored, primarily for corroboration of the basic forecast. This technique was judged to be unsuitable as the principal forecasting method, because 30 to

40 data points are usually required and the process would produce valid results only for a short-term horizon of four to six quarters.

After examining these unsatisfactory options, the PBGC prepared its 1982 request for a premium increase in the following manner: Claims incurred to date were normalized to the most recent interest rate. The average gross claim per termination in each fiscal year was regressed to find a trend line. That regression, which had an R^2 of 0.785, determined that the average gross claim per termination was increasing by \$157,000 per year. The number of terminations per year was forecast by averaging the PBGC's experience from fiscal years 1978 through 1981. (Earlier years were excluded as atypical, because the average number of termination events in those years was significantly higher than in more recent years.) To convert the gross claims estimate to net claims, the historical ratio was applied (excluding fiscal year 1976 data on the basis that they were atypical). These relationships were used to forecast annual net claims through the end of fiscal year 1986. Combining the results of this forecast (average net claims of \$96.8 million for fiscal years 1983 through 1986) with a forecast of administrative expenses and 5-year amortization of the deficit expected as of December 31, 1982, produced a premium estimate of \$5.94. The Corporation proposed this rate, rounded to \$6.00, to Congress in May 1982 for plan years beginning on or after January 1, 1983.

During the 4 years between submission of this request and congressional action on it, the PBGC made numerous revisions to reflect the insurance program's developing experience and the effects of the delay. The premium rate finally adopted, effective for plan years beginning on or after January 1, 1986, was \$8.50 per participant. Unfortunately, events -- notably the very large claims from Allis-Chalmers and Wheeling-Pittsburgh, which occurred in the second half of 1985 -- had rendered this amount insufficient even before it took effect. Accordingly, before final passage, the PBGC advised Congress that, even with the proposed premium increase, it expected the program deficit to continue to rise at a rate of more than \$100 million per year.

The 1984 Study of Forecasting Methodology

In 1984, the PBGC engaged James E. Pesando of the University of Toronto to evaluate ways to forecast the insurance program's financial condition. His February 1985 report, "Projecting Exposure, Terminations, and Claims Among Single-Employer Plans," was based on program experience through fiscal year 1983.

Professor Pesando pointed out that --

... "large" claims arising from a relatively small number of terminations dominate the PBGC claims experience. It is unlikely that the PBGC will be able to obtain accurate forecasts of these large claims, even over a multiyear horizon. Those claims that arise from the larger number of small terminations may prove more "forecastable," yet they represent a relatively small percentage of the total.

This observation was made when the largest net claim against the insurance program was about \$60 million. It became even more pertinent after the Allis-Chalmers, Wheeling-Pittsburgh, and LTV terminations, each of which produced a significantly higher claim than the one before.

Professor Pesando considered both of the approaches to forecasting discussed above, relating experience to macroeconomic variables and analyzing the circumstances of particular sponsors and plans. He found neither promising. His examination of the correlation between PBGC experience and economic variables found "little evidence" of --

systematic relationships that might prove useful in a forecasting context. Even the component of PAI [plan asset insufficiency] linked to small terminations appears to lack a systematic element. There are significant time trends in both the average and total amount of net claims, yet these time trends (in excess of 30% per year) are too rapid to be credible in a forecasting context.. [Emphasis in original].

Efforts to find "a systematic relationship between the various categories of PAI and a set of business cycle variables," the study said, were "quite disappointing. There is no statistically significant relationship between either the raw or wage-deflated PAI data and any of the business cycle variables." (The very large claims incurred in the past two fiscal years, a period of relative prosperity, are unlikely to upset this conclusion.)

The alternative approach -- basing forecasts on analyses of specific plans that present large potential claims -- founders on the difficulties inherent in forecasting bankruptcy or other forms of extreme financial distress. Professor Pesando suggested that bankruptcy prediction models make the process appear easier than it is by concentrating on very healthy and very weak firms, excluding those in the middle range. He also noted how hard it is to judge the ultimate ability of a troubled firm to survive.

* Chrysler and Navistar serve as examples of companies whose demise once seemed certain but has yet to occur.

Finally, even if one could accurately "translate exposure measures into forecasts of insufficient terminations," the study observed that "the projected PAI in the forecast horizon may nonetheless have a wide confidence interval," because "PBGC's exposure is concentrated among so few plans."

In summary, Professor Pesando reached the same conclusion that the PBGC had come to after years of trying to forecast its claims experience: Uncertainties inherent in forecasting what will happen to the handful of plan sponsors that overwhelmingly dominate the program's experience make useful prediction essentially impossible. The rapid, sometimes almost instantaneous, obsolescence of all of the PBGC's premium studies is a kind of empirical confirmation of this view.

Because the PBGC has no valid and reliable way to predict future claims against the insurance program, it recommends that premiums be subject to automatic, periodic adjustment based on a formula established by law. The alternative is to submit frequent requests for congressional enactment of new premium schedules, a procedure whose delays risk further erosion of an already shaky program. This proposed change, coupled with the others recommended in this Report, will do much for the future financial viability of the single-employer insurance program.

Forecasting Premium Needs

Although lacking a reliable way to forecast future claims experience, the PBGC has examined how a variety of economic scenarios would effect its financial condition over the 30-year period from 1987 through 2016. These forecasts used 15 different sets of parameters and calculated premium requirements in 4 different ways for each set. Detailed explanations of the parameters and methods of calculation appear in Appendix A. An abbreviated description follows.

Parameters examined. The forecasts covered all of the factors that significantly affect the program's per capita premium needs, including:

- * Future net claims,
- * Number of participants in PBGC-insured plans,
- * Future rates of inflation,
- * Timing of major claims,
- * Funded levels of terminated plans, and
- * The program's investment return.

As already noted, four methods of calculating premiums were used. Three of these aim at eliminating the program's deficit by the end of the 30-year period. They differ in how they achieve this result. The first method keeps the premium per participant constant in nominal dollars. Thus, the inflation-adjusted premium declines, and the program builds up temporary surpluses.

The second method keeps the premium per participant constant in inflation-adjusted dollars, which requires a much lower initial premium than the previous method. The premium then escalates with inflation and ends at a much higher nominal level. The program's deficit grows for a time, because premiums start at too low a level to fund expected claims and pay interest on accumulated unfunded liabilities. Eventually (if the rate of inflation is as high as expected), premiums reach the level needed to retire the deficit, leaving the program fully funded at the end of the 30-year forecast period. If inflation is more or less than expected, the deficit will be amortized over a shorter or longer period than 30 years. Except for the current deficit, which is not sensitive to future economic conditions, the potential problems of too much or too little inflation would be minimized if premiums were adjusted automatically to reflect changed conditions.

The third method combines features of the first two. The portion of the premium needed to fund future claims and administrative expenses is held constant in inflation-adjusted terms, while the portion allocated to deficit retirement remains constant in nominal terms. The program thus avoids transient surpluses. It also avoids the risk that lower-than-expected inflation will make it impossible to retire the deficit.

The fourth method calculates premiums on a cash flow basis. The premium remains at \$8.50 per participant so long as the program has enough assets to fund expected benefit payments for the next 3 years. When assets dip below that threshold, the premium rises sufficiently to restore a cushion equal to expected benefit payments for the next 3 years.

As Table A-1 in Appendix A shows, by varying assumptions and methods of calculation, it is possible to support any revenue requirement for 1988 between about \$8.50 and \$110.53 per participant. By 2016, the range is between \$33.38 and \$336.54, or between \$2.44 and \$61.64 if the amounts are converted to 1988 dollars. The choice depends both on decisionmakers' views of which scenarios are plausible and on how they decide that program should be funded over time. In addition, if the premium structure does not automatically adjust premium rates in the future, a substantial margin of safety should be built into the forecast. In that case, it might be appropriate to choose relatively pessimistic assumptions and to calculate a constant nominal

premium (the first method described above). On the other hand, if an automatic premium adjustment mechanism is enacted, a premium that will be periodically adjusted to make up shortfalls (or windfalls) can begin at a lower level.

Conclusion

The PBGC has encountered enormous difficulties in its search for a reliable method of forecasting net claims by terminated plans. The Corporation believes that it has aggressively pursued every possible avenue in this search, but it has yet to find a method of forecasting that successfully contemplates the vast and sudden changes that can take place. Given the sensitivity of the program to a few very large claims, it is doubtful that such a method exists.

In lieu of a reliable method of forecasting, the PBGC has undertaken a sensitivity analysis designed to establish the likely boundaries of premium needs for the insurance program in coming years. This analysis establishes the boundaries at \$17 on the low side and \$50 on the high side in per capita annual premiums. The PBGC has chosen \$25 as the most desirable per capita annual premium target.

Chapter IV discusses a premium rate structure that leads to the \$25 target and how an automatic adjustment mechanism would minimize the implications of a mistaken premium target choice.

NOTES -- CHAPTER 3

¹ Department of the Treasury and Department of Labor, Study of Pension Plan Terminations, 1972 (August 1973).

² Although the PBGC did not come into existence until September 1974, earlier terminations were in some instances eligible for insurance coverage.

Chapter IV

RECOMMENDATIONS TO THE CONGRESS

"Not later than one year after the date of the enactment of this Act, the Corporation shall report the results of its study, together with any recommendations for statutory changes...."

SEPPAA, Section 11017(a)(3)

The PBGC has concluded that its current mechanism of charging a flat-rate per capita premium is a major cause of the insurance program's deepening problems, and should be replaced by a structure that reflects the funded status of covered accounts. The PBGC recommends that the Congress enact a system of a variant of the risk-related premium that the PBGC calls a variable-rate premium and presents in this chapter a detailed description of how, in its view, that premium structure should be designed and implemented.

The current flat-rate premium, based solely on the number of plan participants, has been in effect since the PBGC was established in 1974. Congress at that time considered basing premiums on the value of plan liability of some other measure of risk. But Congress expected the program to remain small, and believed that relating the program's de minimis premium needs to risk was an unnecessary refinement.

Contrary to those early expectations, the program has grown enormously, with liabilities growing much faster than assets. PBGC premiums, even if raised to a level sufficient to fund the program, would still be modest compared with many other insurance charges that employers pay routinely, but they are no longer negligible. For this reason, the 99th Congress asked the PBGC to study, among other topics "...alternative premium bases upon which some or all...projected future program costs would be allocated on an exposure-related or risk-related computation, which may take into account the different exposure risks imposed on the Corporation by plan sponsors with different histories and under different circumstances." This chapter presents the Corporation's findings and recommendations in response to this request.

Premium-Setting in the Private Sector

Private insurance companies view premiums as a function of "risk" (the probability that the insured will incur a claim) and "exposure" (the maximum amount of the expected claim). A company that ignores or misjudges these factors either will sell no insurance or will lose money by selling insurance at a price too low to cover the claims made against it.

If private firms offered pension insurance, they would certainly not base premiums on a flat rate per plan participant. Rather, they would estimate risk and exposure and charge commensurate amounts for coverage. Some plan sponsors would be so weak that the cost of insurance would approach the present value of the plan's unfunded insured benefits; in other instances, the cost would be negligible, either because all benefits would be fully funded or because the sponsor could clearly underwrite the plan for the indefinite future.

Arguments for a Risk-Related Premium

Many commentators have suggested that the PBGC follow the example of the private sector and change its flat-rate premium to one based on risk. Advocates advance several arguments to support this position.

1. Elimination of implicit subsidies. A flat-rate premium is a form of transfer program under which sponsors of less risky defined benefit plans subsidize sponsors of riskier plans. This subsidy operates behind the veil of PBGC "insurance," but is not difficult to discern. Firms in financial difficulty naturally attempt to reduce labor costs, including pension plan contributions. In the absence of PBGC insurance, however, the pension promises of an ailing employer are valuable to workers only to the extent that they are funded. Without pension insurance, reduced employer contributions would be tantamount to reduced employee compensation and would be possible only to the extent that the employer could extract wage concessions from its workforce.

The existence of the PBGC insurance program changes this picture by making unfunded pension promises almost as valuable as those that are funded. A firm can therefore cut pension contributions, use the savings elsewhere, and maintain wages at the same level as before. In some cases, the firm will return to financial health and restore the lost pension funding; in others, it will fail, and its unfunded promises will fall on other PBGC premium payers. The economic effects are about the same as if employers were compelled to lend money to financially strapped rivals so that the latter could meet their payrolls.

The subsidy-like consequences of the current premium structure are widely acknowledged by both supporters and critics of reform. The controversy concerns relative costs and benefits.

Critics of the use of the insurance program as a vehicle for transferring corporate wealth can point to two ill effects. First, the program diverts premium dollars from more successful (and presumably more productive) firms to less successful ones. Second, it penalizes sponsors of plans that present little risk or exposure to the PBGC and thus discourages them from maintaining PBGC-insured plans.

Supporters of the current premium structure counter that PBGC assessments are too minute to affect the efficiency of the American economy or defined benefit pension plan coverage. This response is plausible, but far from conclusive. The difficulties of gauging the insurance program's effects are attributable to the bluntness of available measuring tools; the effects may nonetheless exist. Moreover, the PBGC currently has a palpable influence on the steel industry, where the benefits have manifestly flowed to the weakest competitors. By subsidizing less efficient companies, the insurance program jeopardizes the survival of the more efficient and complicates the already perplexing task of restructuring the steel industry to meet modern competitive challenges.

In addition, escalating PBGC premiums increase the likelihood that the flat-rate structure will induce employers to abandon defined benefit plans. When the premium was \$2.60 per head, its effects were probably de minimis; now, when the PBGC needs approximately ten times as much in revenue, the effect of the premium on incentives must be carefully considered.

2. Effect on plan funding. A risk-related premium is said to encourage all plan sponsors -- including prosperous ones -- to maintain higher funding levels. This argument contends that it is prudent to encourage sound pension funding even when plan termination is a remote prospect, because a sponsor's condition can change rapidly.

A risk-related premium may influence employers' funding decisions even where the penalty for underfunding is much smaller than are the plan contributions needed to avoid the penalty. The economic benefit to a firm from minimizing its pension contributions is the difference between its own rate of return on the amount saved and the pension trust's rate of return (after taking into account differences in tax treatment). The PBGC premium may be significant compared with the gains that accrue from underfunding, so that a premium related to risk will make poorly funded plans measurably less attractive to maintain.

To avoid overstating the case, it is important to note that higher premiums are unlikely to alter the behavior of very weak plan sponsors. For troubled companies, cash flow is often the overriding concern, and, under almost any conceivable structure, the contribution of one additional dollar to an underfunded plan would save much less than one dollar in premiums. Hence, the primary effect of a risk-related premium on funding would be to inhibit the maintenance of underfunded plans by healthy sponsors and thus reduce the risk of future claims if these firms should encounter financial difficulty.

3. Equity among premium payers. Finally, the current premium structure has been challenged on grounds of equity. One can view PBGC premiums either as fees or taxes. In either view, the program may not conform to the principles of fairness that generally underlie (or ought to underlie) the imposition of other governmental assessments. As a fee, the premium is not commensurate with the benefits that the payers receive. As a tax, it is levied on an arbitrarily chosen segment of the population.

It can be argued, on the other hand, that, unless the premium mechanism were extraordinarily complex, premiums would be equitable only in a rough and ready way. There is no certainty that the inevitable compromises and simplifications of a real-world premium would actually allocate burdens any more fairly than does the current structure.

Arguments Against a Risk-Related Premium

Critics respond to the case for premium reform with a number of arguments:

1. Economic benefits of PBGC subsidies. The insurance program's alleged subsidies to weak plan sponsors are sometimes defended on the ground that they help to save firms that would otherwise fail. Some anecdotal evidence supports this view. Its proponents also claim that unreasonably high premiums would deal a fatal blow to firms now on the brink of bankruptcy.

Even if the flat-rate premium has favorable economic effects in some cases, the key question remains whether these benefits outweigh the costs. It is not likely. The PBGC's insurance program is not set up to be an efficient dispenser of subsidies. Its implicit payments bear no relationship to the recipient's probability of success or contribution to the economy. A more efficient mechanism would charge plan sponsors the full value of their pension insurance coverage and then dispense direct subsidies to firms for which the full premium would be an excessive burden and where a solid case existed for subsidization.

2. Effect on strong sponsors of underfunded plans. Basing insurance premiums on plan characteristics (e.g., amount of underfunding or the ratio of assets to the present value of liabilities) is relatively straightforward. Including sponsor characteristics is much more difficult, and they are not taken into account, except to a very limited degree, in the PBGC's recommended premium structure.

Nevertheless, some financially strong and stable firms maintain underfunded defined benefit plans. These sponsors presumably believe that they can earn a higher rate of return by investing funds in their own businesses than by contributing the same amounts to their pension plans. To the extent that they are correct, it is argued, their failure to fund their plans does not jeopardize the PBGC and ultimately redounds to the benefit of their stockholders and employees. Hence, a risk-related premium that looked only at the state of the plan would impose unfair burdens and impede economic efficiency.

This argument would have merit if reliable, long-term indicators of sponsor strength existed. But if they exist, they have yet to be found, and the PBGC therefore recommends against setting premiums on the basis of sponsor characteristics. Experience shows that a firm's financial condition can change very rapidly, and a pension plan that was underfunded in good times is hardly likely to become better funded in bad.

- 3. Excessive complexity and cost of premium collection. A frequently heard argument is that, whatever its other defects, a flat-rate premium is infinitely simpler to administer and collect than any risk-related alternative. The latter, it is said, would not only require greater PBGC resources but would also complicate the operation of plans.

The PBGC agrees that administrative ease is a key consideration in designing a new premium structure. Therefore, its recommendation is designed to use only data that are routinely assembled by all PBGC-insured plans and to require a minimum of additional computation.

The PBGC's Recommendation

The PBGC concludes that flat-rate premiums that do not take into account either exposure or risk of loss have serious flaws. Under the current system, premium dollars are in effect transferred from strong sponsors of healthy pension plans to weak sponsors of poorly funded plans. These subsidies undermine the economy and penalize firms that desire to establish or maintain PBGC-insured plans.

The defects in this premium structure have always posed a threat to the PBGC program. The recent sharp increase in the program's revenue needs magnifies these defects. For this reason, the PBGC recommends a new premium structure under which firms whose plans create greater exposure for the insurance program will pay premiums commensurate with the costs that they impose.

Criteria for a Reformed Premium Structure

The PBGC has identified criteria that a new premium structure should satisfy to correct the flaws of the current system and meet the program's future needs.

1. Simplicity. The new structure should be readily understood by plan administrators and should be enforceable by the PBGC without any major expansion of resources. It should not require the collection of substantial amounts of additional data or the performance of burdensome actuarial calculations.
2. Equitable allocation of premium charges. Those plans that present the greatest risk and exposure to the PBGC's insurance program should pay the highest premiums. Plans that present little risk should pay a smaller premium covering program expenses and the current deficit, which cannot reasonably be allocated on a risk- or exposure-related basis.
3. Avoidance of unreasonable transitional burdens. Because the new premium structure would represent a fundamental change in philosophy, a limitation should be placed on the immediate increase in premium costs.
4. Adequate revenue for the program's needs. The new premium should raise enough revenue to cover anticipated claims and retire the program's existing deficit over a reasonable period of time.
5. Automatic adjustment of premiums to reflect future needs. Because claims against the program are not easily predictable, an automatic adjustment mechanism should be instituted to keep the program's revenues in line with its needs and avoid the buildup of new deficits in the future.

Alternative Premium Structures

The PBGC has considered several alternative risk-related structures. Many alternative ways to relate premiums to risk and exposure were considered by the PBGC staff. These studies are summarized in Appendix B. Their conclusion was that the best approach was to adopt a simple premium structure that is a variant of the risk-related premium; the Corporation calls this a variable-rate premium.

Alternative funding policies -- particularly methods of amortizing the insurance program's current deficit -- are also discussed in Appendix B. The PBGC's conclusion is that, if the new premium structure includes an adequate adjustment mechanism, the deficit can reasonably be amortized over 30 years in a manner that keeps the annual amortization charge constant in inflation-adjusted dollars. This policy will minimize the immediate increase in premiums and the consequent burden on plan sponsors. Without an adjustment mechanism, substantially higher initial premiums would be needed to avoid the risk of eventual depletion of the program's assets.

Elements of a Variable-Rate Premium Structure

The PBGC proposes a variable-rate premium structure that satisfies the criteria set forth above. This proposal includes:

- * A flat-rate participant charge, equal to the current rate and indexed to increases in wages, to be paid by all plans;
- * An additional "funding charge" based on the difference between a specified "funding target" and the value of plan assets, to be paid by all plans with 100 or more participants that do not have sufficient assets to meet the funding target;
- * A "cap" on how much any plan would pay per participant, which would be increased more rapidly than the wage index and thus would be phased out very gradually;
- * An additional charge for plans that had recently obtained minimum funding waivers or failed to meet minimum contribution requirements; the additional charge would be higher where plan underfunding would significantly increase as a result of plant shutdown or layoffs;
- * Automatic adjustment of the funding charge at specified intervals, to reflect differences between the insurance program's actual and projected financial condition; and
- * Placement of the liability for premiums on the plan sponsor and members of its controlled group.

If fully implemented, the proposed premium structure could have produced approximately \$775 million revenue in 1986. The estimate is sensitive to the distribution and degree of underfunding that actually exists in each year. The PBGC estimates that revenues from this structure will be sufficient, over the next 30 years, to fund new net claims of about

\$600 million per year (in constant 1987 dollars) and to eliminate the PBGC's \$3.8 billion deficit. (These estimates assume average growth in nominal wages of 6.25 percent per year, consistent with the long-term interest rates currently used to value the insurance program's liabilities.)

Detailed Explanation

1. Flat-rate portion of the premium. The proposed premium structure imposes two charges, one a per-participant charge paid by all single-employer plans and the other a percentage of the difference between each plan's assets and its "funding target." The flat-rate premium covers the program's administrative expenses and the cost of retiring the deficit. These costs are not considered appropriate for a premium based on underfunding. Administrative costs comprise general overhead and cannot be related in any clear way to funded status. The deficit is, in part, the outcome of terminations that occurred in the relatively distant past and is not easily related to the characteristics of the current generation of plans.

The PBGC recommends retaining the current rate of \$8.50 per participant per year, which is adequate to pay administrative costs and deficit amortization and to make a small contribution toward net claims costs. This figure should be indexed to wage growth, so that employers can be confident that it will remain reasonably constant as a proportion of payroll.

2. Funding charge. In addition to the flat-rate premium, each plan would pay a "funding charge" of \$6.00 per \$1,000 of "funding target insufficiency." The latter figure would be computed by subtracting the value of the plan's assets from 125 percent of the present value of its vested benefits.

Several important limitations accompany the funding charge. First, the charge would not apply to any plan with fewer than 100 participants (thus excluding 80 percent of PBGC-insured plans, although the excluded plans cover fewer than 6 percent of PBGC-insured plan participants). Second, certain benefits would be disregarded in calculating the funding charge. Benefits for which insurance company annuity contracts had been purchased (and the corresponding contract assets owned by the plan) would be disregarded. In addition, if an employer gave the PBGC a security interest in assets equal to the amount of plan underfunding plus a cushion, plan benefits would be exempt from the funding charge. The PBGC would, of course, have to approve the particular arrangement.

Plan assets and liabilities would be as reported on Schedule B to the plan's annual report (Form 5500), with liabilities standardized to the PBGC's closeout interest rate. Plans with more than 5,000 participants would be required to conduct a

valuation using the PBGC rate; smaller plans could use conversion tables developed by the PBGC.

Although plans with equal unfunded benefits but lower funded percentages are likely to be riskier, the PBGC decided not to "complicate" the formula with different rates depending on the percentage of funding. Because financial troubles can strike very quickly, it is prudent to charge higher premiums to any firm that fails to fund its pension promises adequately.

Pension obligations are long-term commitments. Therefore, the cutoff for the funding charge is set above 100 percent funding of vested liabilities. This factor recognizes the risk that a plan that is fully funded for vested liabilities may become inadequately funded if conditions change. Sponsors that wish to avoid the funding charge can do so by annuitizing benefits, thus eliminating market risk.

3. Maximum premium rate. The total of the per-participant charge plus the funding charge would not exceed \$100.00 per participant. This cap would be indexed to 1.5 times wage growth and thus should apply gradually to fewer plans as the years go by. For example, if wages increase 5 percent, the cap would increase 7.5 percent. (See Table IV-1 showing premium levels for plans subject to the funding charge.)

4. Funding waiver surcharge. The proposed premium structure includes a surcharge for plans that have recent funding waivers or unpaid contributions. These events constitute a company's declaration of distress and provide a simple basis for a risk surcharge. The unpaid contributions provide a simple basis for a risk surcharge. Employers that do not make required contributions are, in effect, turning to their pension plans -- and the benefits they have promised to their employees -- for low-cost financing. The effect of these surcharges is to increase the cost of that financing. The surcharge would be a percentage of the funding charge otherwise due, and would not be subject to the \$100.00 (indexed) per-participant premium cap.

A surcharge would apply to plans that fail to satisfy the minimum funding standards in the future (i.e., for plan years beginning in 1988 or later) without obtaining a waiver or extension of amortization period. The surcharge would be 50 percent of the funding charge for each missed contribution, and would remain at 50 percent for 5 years, unless the missed contribution is made sooner.

A plan that in the future (i.e., for plan years beginning in 1988 or later) receives a funding waiver or extension would also pay a surcharge. This surcharge would be 50 percent of the funding charge if the waiver is 1 year old, 40 percent if it is 2 years old, etc. A plan that receives five consecutive minimum

Table IV-1

Schedule of PBGC Premiums

(Plans With 100 or More Participants Only)

\$6 per \$1,000 in Unfunded Vested Liability
for Funding Levels Below 125%

\$8.50 Base and \$100 Maximum Premiums

Premium Level	Premiums	Vested Participants	Plans
\$8.50	20.9%	60.7%	60.4%
8.51-20.00	7.8	15.0	15.2
20.01-35.00	6.2	5.7	8.3
35.01-50.00	8.1	4.2	4.6
50.01-75.00	8.3	3.5	4.2
75.01-99.00	8.3	2.3	2.4
100	39.8	8.5	4.7

Average Premium: \$24.40 per vested participant.

Numbers in this table depict estimated funding levels in single-employer plans in 1986 and would have been used for 1987 premium assessments if the new premium structure had then been in effect. Projections of unfunded vested benefits used to calculate premiums were based on actual 1984 funding ratio distributions from the 5500 annual reports (90% complete), adjusted to 1986 using Johnson-Higgins and Greenwich Associates published numbers for 1985 and 1986, converted to PBGC interest rates.

All numbers reflect vested active participants and retirees only; non-vested workers are not included.

Source: PBGC staff calculations.

funding waivers (the maximum under current law) would face a 150 percent surcharge. If the waived amounts were paid before the end of the 5-year surcharge period, the surcharge would cease.

These surcharges apply to situations in which employers are granted waivers and those in which a waiver may be pending or may not have been requested. Because the granting of a funding waiver is intended to indicate that hardship is temporary, the amount of the surcharge for those situations decreases over time. In both types of situations, the surcharge ceases after 5 years because a plan that survives for 5 years after missing a contribution is likely to be able to continue in existence.

The funding surcharge would be doubled for plans that have unfunded vested liabilities and also have large contingent obligations that are related to plant shutdowns and similar situations. These types of benefits are particularly troublesome for the PBGC. A plan that provides shutdown or similar benefits presents an increased risk to benefit security and to the insurance system. The benefits typically are large and they can be triggered virtually overnight.

5. Adjustment mechanism. Provision for automatic adjustments (i.e., without need for congressional action) should be made to limit the risk of future deterioration in the program's finances or of collecting more revenues than are needed for the program. The PBGC proposes adjusting the funding charge rate every 3 years in light of experience during those years. The based \$8.50 (indexed) per-participant premium and the maximum \$100 (indexed) per-participant premium would not be subject to the adjustment mechanism.

The adjustment would have three principal components. First, the funding rate charge would be adjusted to reflect any revision in projected annual net claims. Revised projected annual net claims would be set equal to the average of the most recent 3 years' actual net claims, adjusted to current dollars. This approach would avoid subjective projections that lack a solid empirical or theoretical basis.

Second, any difference between the actual deficit at the end of a 3-year period and the deficit amount that had been projected for that date would be amortized through a further adjustment of the funding charge rate. Third, the funding charge rate adjustment would take into account changes in the premium bases (number of participants and funding target insufficiency). However, in no event would the funding charge rate be changed by more than 50 percent by these combined adjustments as a result of a triennial review.

While no premium adjustment mechanism that contains limitations on premium increases can guarantee that the program

will remain solvent under all conceivable scenarios, this proposal should come close to that goal. At the same time, the adjustment mechanism assures that favorable experience will result in prompt reductions in premiums.

6. Controlled group liability for premiums. Under current law, premiums are liabilities of the plan. Thus, increased premiums simply increase plan underfunding. At termination, higher premiums may result in benefit losses to participants. In addition, the PBGC's right to recover unpaid premiums is limited at termination. Some premiums may not be collectible at all because they will be post-termination charges to plan assets after plan asset insufficiency is measured for purposes of the PBGC's employer liability claim. The responsibility for plan funding ultimately lies with the controlled group maintaining the plan. This is where the responsibility for payment of premiums should also be placed.

NOTES -- CHAPTER 4

¹ SEPPAA, §11017(a)(2)(G). Earlier, the Multiemployer Pension Plan Amendments Act of 1980, P.L. 96-364, §412(a)(1)(A), had instructed the PBGC to conduct a risk-related premium study. Substantial work, much of which is incorporated into this Report and Appendices, was accomplished, but the study was not released. A preliminary version was circulated to interested Government agencies for comment in late 1983. A revision reflecting the comments received and further staff analysis was completed in January 1985. At that point, the PBGC decided that the publication of a report should await the enactment of single-employer program reforms requested by the Administration. After the passage of SEPPAA, the project was merged with the current Report.

² Changes in the deficit are caused primarily by deviations between actual and expected net claims, valuation interest rates, investment experience, mortality experience, and premium rate bases (i.e., the number of participants and the funding target insufficiency). Changes in the deficit would be amortized over 30 years in constant dollars.

Appendix A

ALTERNATIVE CLAIMS FORECASTS

As is discussed in Chapter III of this Report, it is very difficult to forecast future claims and therefore the premium needs of the Corporation. Nevertheless, the PBGC believes that it is important to understand how the Corporation's financial condition and premium needs could be affected if various scenarios were to occur. These scenarios include varying claims levels, varying number of participants covered by the insurance program, changes in the degree to which terminated plans are funded, changes in interest rates, etc. Therefore, the PBGC staff has produced such forecasts for a wide range of scenarios.¹ All of the forecasts were done for the 30-year period, 1987-2016.

For each of the forecasts, pro forma financial statements were produced, including income statements, balance sheets, and cash flow analyses. Premiums were calculated for each scenario under four different funding policies. The premium calculated was that required to fund expected future claims, pay administrative costs, and retire the existing deficit. These three components (which determine total revenue needs) were compared with the expected number of covered participants to determine premium needs on a per-participant basis.

Unless otherwise noted, investment income was assumed to equal the actuarial assumption, and other experience was also assumed to be consistent with the actuarial assumptions. These assumptions are made in order to avoid producing actuarial gains or losses. The presumption is that the actuarial assumptions reflect the best current estimate of future investment earnings, mortality, etc., and therefore ought to be the basis for all baseline and other forecasts that are not specifically designed to test the sensitivity of the program to these assumptions.

Methods of Calculating Premium Requirements

The first of the four funding policies used to calculate premium requirements under each scenario determined the constant premium (in nominal dollars) that would be needed to fund future claims and administrative expenses as incurred and to retire the existing deficit over 30 years.

The second funding policy determined the constant premium, in inflation-adjusted dollars, that would be needed to reach the same goal as the first method. The premium was escalated using an annual wage growth rate of 6.25 percent. (This rate is judged to be consistent with an assumed consumer price index growth rate of

5.25 percent per year and expected return on investments of 7.25 percent per year.) This approach keeps the premium in real terms unchanged and also has the effect of making the premium much lower in the early years and higher in the later years (in nominal dollars) than it would be under the first funding policy. For instance, under the baseline scenario, a level premium for the period 1988-2016 is \$54.05, whereas an escalated premium starts at \$25.64 in 1988 and ends at \$140.00 in 2016. The extent of this difference is highly sensitive to both the length of the forecast period chosen and the rate assumed in adjusting from nominal to real terms.

The third funding policy combines the above two approaches. Future claims and administrative costs were calculated in real terms, as under the second policy, with each year's expected claims and administrative costs reflected in that year's premium requirement. In contrast, the deficit was amortized in nominal terms, as under the first policy. This approach reflects the philosophy that the deficit represents a fixed stream of future benefit payments. The greatest uncertainty is over what interest rate should be used to discount this stream back to today in order to establish its present value. Because benefit payments are guaranteed in nominal dollars, the portion of the premium required to retire the deficit ought also to be expressed in nominal terms.

The fourth funding policy calculated premium needs on a cash flow basis. The premium remained at \$8.50 as long as the program had enough assets to fund the expected benefit payments for the next 3 years. At that point, the premium was raised by whatever amount was needed to restore the 3-year cushion. This analysis was intended to illustrate the lowest possible premium that would still ensure that the PBGC had enough assets on hand to satisfy future benefit payments as they became due.

The premiums calculated under each scenario and funding policy are presented in both nominal and 1988 terms (based on assumed inflation), so that both the dollars involved and their economic burden under future economic conditions could be assessed. For all of these scenarios, projections were made for each of the 30 years between 1987 and 2016.

Basic Assumptions

Fifteen scenarios were analyzed. The first two are generally consistent with the scenarios included in the Fiscal Year 1986 Actuarial Report submitted to the President and the Congress in March 1987. The third scenario is that used to determine expected revenue needs for illustration in this Report and as the basis for the premium revenue requirements in the premium legislation that the Administration is submitting to the Congress. The remaining 12 scenarios are intended to explore the sensitivity of the PBGC's financial condition and premium needs to other possible

scenarios. Unless otherwise noted, the following assumptions were used in all of the forecasts:

1. Net claims were projected by combining the annual average of net claims experienced during all of the PBGC's 12 years and the average of net claims experienced during the ~~past 5~~ years (1982-86). (In both cases, claims pending at the end of fiscal year 1986 were included.) This procedure has the effect of giving double weight to the past 5 years, when claims were significantly higher than previously. Before calculating this average, all claims were adjusted to fiscal year 1986 dollars. Future claims were assumed to grow at the rate of 7.84 percent. This percentage increase was intended to keep the claim per covered participant level after adjusting for expected wage growth. Assets of PBGC-trusted plans were assumed to remain at 40.88 percent of guaranteed benefits, and employer liability was assumed to remain at 6.19 percent of the plan asset insufficiency. These ratios were based on the averages in the same way as the overall net claims estimate was calculated.

2. Administrative expenses for fiscal years 1987 through 1992 were set equal to the assumed single-employer portion of the Corporation's fiscal year 1988 operating budget that was submitted by the President to the Congress. They were assumed to increase thereafter at a rate of 6.25 percent.

3. Participants for whom a premium will be collected were based on the previous estimate for fiscal year 1986 of 31.6 million and on the assumption that they will grow thereafter at an annual rate of 1.5 percent.

Fifteen Scenarios Analyzed

Following are descriptions of the 15 scenarios studied:

1. Twelve-year average claims forecast -- This forecast is based on the assumptions described above, except that claims are forecast based solely on the average of the PBGC's claims experience over its entire 12 years of history. No additional weight is given to the most recent years. This scenario represents the view that all of the PBGC's experience is equally relevant in trying to forecast what future claims will be. In this case, plan assets constitute 40.97 percent of guaranteed benefits and employer liability 6.88 percent of the plan asset insufficiency.

2. Five-year average claims forecast -- This forecast uses only the PBGC's experience for the past 5 years in determining the average level of claims to expect in the future. Only the past 5 years were used, because the PBGC's claims level experienced a substantial increase in fiscal year 1982. Under this scenario, average claims are about double the forecast based

on all of the PBGC's history, plan assets constitute 40.79 percent of guaranteed benefits, and employer liability is 5.50 percent of the plan asset insufficiency.

3. Combination of 12-year and 5-year average claims ("baseline") forecast -- Under this scenario, claims are forecast to be the average of the claims forecast under the previous two scenarios. Thus, more weight is given to the PBGC's most recent experience. This scenario thus produces a claims forecast about half way between the previous two. It is referred to as the "baseline" forecast, because most of the remaining 12 scenarios use this scenario as a starting point. This scenario is also used for purposes of determining the PBGC's revenue needs in main part of this Report.

4. No growth in the number of covered participants -- This scenario is intended to illustrate what would happen to the PBGC's premium if the historical growth rate in covered participants ceased and the number of covered participants remained constant at the expected fiscal year 1986 level of 31.6 million.

5. Decline in the number of covered participants -- This scenario is more extreme than scenario #4 in that it assumes a 10 percent decline in the number of covered participants in each of the next 3 years. Thereafter, the number of participants is assumed to resume its historical growth rate of 1.5 percent annually.

6. Additional steel company terminations -- This scenario is intended to illustrate what would happen if three more troubled steel firms were to terminate their pension plans in the next 3 years. For illustrative purposes, these terminations are considered to be in addition to those already included in the baseline forecast.

7. Lower claims growth rate -- Under the baseline scenario, claims are expected to grow at a rate of 7.84 percent per year. This scenario is designed to explore what would happen if the rate of claims growth slowed. The rate of claims growth under this scenario is 4.67 percent, which is consistent with assuming one-half the previously assumed wage growth rate of 6.25 percent.

8. More poorly funded plans terminate -- Historically, terminated plans with net claims against the PBGC have had plans assets equal to 40.88 percent of their guaranteed benefits upon termination. This ratio has varied somewhat over time and may deteriorate in the future. In order to test the sensitivity of the program to this assumption, this scenario assumes that future plan terminations will be only 20 percent funded.

9. Most recent (biggest) claims first -- In addition to the magnitude of net claims, their timing can be important in determining overall revenue needs, particularly when the premium is calculated on a cash flow basis. Because PBGC's largest claims have occurred in recent years, this scenario produces higher premium requirements.

10. Oldest (smallest) claims first -- This scenario was designed to test the opposite of scenario #9.

11. Higher inflation (assets of short maturity) -- Another factor that can have considerable effect on PBGC's premium needs and its financial condition is change in the cost of living and interest rates. This scenario assumes that claims and administrative costs will start growing at a 5 percent higher rate starting in the eleventh year (1997) of the forecast period. This assumption causes both of these items to grow more rapidly. The higher inflation rate, however, reduces the present value of the benefits already insured by the PBGC. A similar effect is also assumed to occur with the present value of liabilities of future terminations. Because assets are assumed to be of short maturity, they are not expected to decline in value as interest rates rise. This assumption has the effect of increasing both the funded percentage of the insurance program and the degree to which plans terminated after 1996 are expected to be funded.

12. Higher inflation (assets of long maturity) -- This is identical to the scenario #11, except that assets are assumed to have the same duration as liabilities and therefore to decline in value, when interest rates increase, by the same percentage as the decrease in liabilities.

13. Lower inflation (assets of short maturity) -- This scenario is designed to be the opposite -- and therefore to illustrate the opposite effect -- of scenario #11.

14. Lower inflation (assets of long maturity) -- This scenario is designed to be the opposite -- and therefore to illustrate the opposite effect -- of scenario #12. It differs from scenario #13 in that assets are long and therefore appreciate in value when interest rates fall. In contrast, scenario #13 assets are short and therefore do not appreciate in value to make up for or offset the increase in the present value of the liabilities that occurs when interest rates fall.

15. Extreme or "Armageddon Special" -- This scenario is designed to illustrate what would happen if several unfavorable things happened simultaneously. In this illustration, the claims average from only the past 5 (rather than from an average of 5 and 12) years is used, plans are assumed on average to be 20 percent funded (rather than the current average of 40.88 percent), and the current participant count of 31.6 million is assumed to remain

constant rather than to continue to grow at a rate of 1.5 percent per year.

Results

Table A-1 summarizes the results of the analysis for each of the 15 scenarios. The required premium rate is provided for 1988, 1996, 2006, and 2016 in both nominal and 1988 dollars. The table also provides for each scenario: (1) the premium required under a flat or level approach; (2) an indexed approach that keeps the premium constant in real terms; (3) a premium that covers claims and administrative costs in real terms, but retires the deficit in constant nominal terms; and (4) a premium that is designed to keep enough assets on hand to meet the next 3 years' worth of benefit payments.

TABLE A-1

**Summary of Premium Requirements
Under Alternative Forecast Assumptions**

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #1								
Twelve-year average claims forecast								
Flat	39.12	39.12	39.12	24.09	39.12	13.14	39.12	7.17
Indexed	18.56	18.56	30.14	18.56	55.26	18.56	101.32	18.56
Scenario #2								
Five-year average claims forecast								
Flat	68.99	68.99	68.99	42.48	68.99	23.17	68.99	12.64
Indexed	32.73	32.73	53.16	32.73	97.46	32.73	178.70	32.73
Scenario #3								
Constant Amortization of Deficit								
Flat	25.27	25.27	32.68	20.12	50.28	16.89	83.59	15.31
Indexed	8.50	8.50	21.97	13.53	40.34	13.55	73.62	13.48
Scenario #4								
Constant Amortization of Deficit								
Flat	40.17	40.17	56.09	34.54	92.28	30.99	159.80	29.27
Indexed	8.50	8.50	30.64	18.87	72.73	24.43	143.76	26.33

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #3								
Combination of 12 year and 5 year average claims ("baseline") forecast								
Flat	54.05	54.05	54.05	33.28	54.05	18.15	54.05	9.90
Indexed	25.64	25.64	41.65	25.64	76.36	25.64	140.00	25.64
Scenario #4								
Constant Amortization of Deficit	32.72	32.72	44.38	27.33	71.28	23.94	121.69	22.29
Cash Flow	8.50	8.50	26.25	16.16	56.50	18.97	108.62	19.89
Scenario #4								
No growth in the number of covered participants								
Flat	64.49	64.49	64.49	39.71	64.49	21.66	64.49	11.81
Indexed	32.48	32.48	52.75	32.48	96.72	32.48	177.34	32.48
Constant Amortization of Deficit	33.72	33.72	51.52	31.73	96.01	32.25	190.23	34.85
Cash Flow	8.50	8.50	30.46	18.76	76.10	25.56	169.78	31.09

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #5								
Decline in the number of covered participants								
Flat	76.97	76.97	76.97	47.39	76.97	25.85	76.97	14.10
Indexed	36.68	36.68	59.57	36.68	109.22	36.68	200.26	36.68
Constant Amortization of Deficit	41.71	41.71	63.76	39.26	102.33	34.37	174.63	31.99
Cash Flow	8.50	8.50	37.65	23.18	81.05	27.22	155.81	28.53
Scenario #6								
Additional steel company terminations								
Flat	61.60	61.60	61.60	37.93	61.60	20.69	61.60	11.28
Indexed	29.22	29.22	47.46	29.22	87.02	29.22	159.56	29.22
Constant Amortization of Deficit	110.53	110.53	44.38	27.33	71.28	23.94	121.69	22.29
Cash Flow	8.50	8.50	42.19	25.98	69.02	23.18	114.11	20.90

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #7								
Lower claims growth rate								
Flat	38.58	38.58	38.58	23.76	38.58	12.96	38.58	7.07
Indexed	18.30	18.30	29.72	18.30	54.50	18.30	99.93	18.30
Scenario #8								
Constant Amortization of Deficit	31.50	31.50	35.88	22.09	44.22	14.85	56.47	10.34
Cash Flow	8.50	8.50	25.60	15.76	45.79	15.38	68.72	12.59
Scenario #8								
More poorly funded plans terminate								
Flat	70.57	70.57	70.57	43.45	70.57	23.70	70.57	12.93
Indexed	33.48	33.48	54.38	33.48	99.70	33.48	182.80	33.48
Scenario #8								
Constant Amortization of Deficit	40.92	40.92	57.26	35.26	94.37	31.69	163.58	29.96
Cash Flow	8.50	8.50	38.59	23.76	79.13	26.58	150.11	27.50

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #9								
Most recent (biggest) claims first								
Flat	43.71	43.71	43.71	26.91	43.71	14.68	43.71	8.01
Indexed	20.74	20.74	33.68	20.74	61.75	20.74	113.22	20.74
Scenario #10								
Oldest (smallest) claims first								
Flat	35.41	35.41	35.41	21.80	35.41	11.89	35.41	6.49
Indexed	16.80	16.80	27.28	16.80	50.02	16.80	91.72	16.80
Scenario #11								
Constant Amortization of Deficit								
Constant Amortization of Deficit	26.59	26.59	20.72	12.76	25.66	9.62	39.05	7.15
Cash Flow	8.50	8.50	29.19	17.97	51.49	17.29	101.90	18.67

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #11								
Higher inflation (assets of short maturity)								
Flat	33.38	33.38	33.38	20.55	33.38	7.08	33.38	2.44
Indexed	13.23	13.23	21.49	13.23	62.41	13.23	181.25	13.23
Scenario #12								
Higher inflation (assets of long maturity)								
Flat	50.82	50.82	50.82	31.29	50.82	10.77	50.82	3.71
Indexed	18.45	18.45	29.97	18.45	87.03	18.45	252.73	18.45
Scenario #13								
Constant Amortization of Deficit								
Constant	32.72	32.72	44.38	27.32	29.59	6.27	105.47	7.70
Cash Flow	8.50	8.50	26.38	16.24	42.35	8.98	108.92	7.95
Scenario #14								
Constant Amortization of Deficit								
Constant	32.72	32.72	44.38	27.32	69.75	14.79	190.15	13.88
Cash Flow	8.50	8.50	26.38	16.24	66.87	14.18	180.12	13.15

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #13								
Lower inflation (assets of short maturity)								
Flat	88.28	88.28	88.28	54.35	88.28	48.01	88.28	42.40
Indexed	54.39	54.39	88.34	54.39	100.02	54.39	113.25	54.39
Scenario #14								
Lower inflation (assets of long maturity)								
Constant Amortization of Deficit	32.72	32.72	44.38	27.32	114.73	62.39	122.63	58.89
Cash Flow	8.50	8.50	26.09	16.06	66.57	36.20	95.90	46.06
Scenario #15								
Lower inflation (assets of long maturity)								
Flat	60.86	60.86	60.86	37.47	60.86	33.09	60.86	29.23
Indexed	39.11	39.11	63.53	39.11	71.93	39.11	81.44	39.11
Scenario #16								
Lower inflation (assets of long maturity)								
Constant Amortization of Deficit	32.72	32.72	44.38	27.32	78.96	42.93	86.01	41.30
Cash Flow	8.50	8.50	26.09	16.06	45.15	24.55	71.64	34.41

TABLE A-1 (Continued)

SCENARIOS	1988		1996		2006		2016	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
Scenario #15 Extreme or "Armageddon Special"								
Flat	108.42	108.42	108.42	66.76	108.42	36.41	108.42	19.86
Indexed	54.61	54.61	88.69	54.61	162.62	54.61	298.17	54.61
Constant Amortization of Deficit	52.60	52.60	84.91	52.28	165.51	55.58	336.54	61.64
Cash Flow	8.50	8.50	54.54	33.58	138.33	46.46	310.62	56.90

NOTES -- APPENDIX A

1 The projections usually assume that the premium will remain at \$8.50 per participant for 1987 and that whatever premium increase is required will be effective January 1, 1988. Of course, for the cash flow-based premium, the increase usually occurs later.

Appendix B

SETTING AND ADJUSTING PREMIUMS

The PBGC's fundamental goal in setting insurance program premiums is to collect enough revenue over time to satisfy all benefit obligations when they come due. Chapter III of this Report discusses some of the difficulties involved in determining the required level of revenue. This appendix examines how knowledge of the program's financial condition is translated into decisions concerning premium levels.

Setting a premium requires a "funding policy." The benefits for which the PBGC is responsible are payable over many years. In the long run, sufficient premiums must be collected so that, when investment earnings and other assets are taken into account, the program will be able to meet all of its obligations.

The basic parameter in the funding policy is the timing of premium collections. The earlier premiums are collected, the lower they will be in nominal terms, because a larger portion of the program's costs will be paid from the earnings that the premiums generate. The policy poles are (a) funding all claims as soon as they are incurred ("full funding") and (b) funding claims little by little as payments to beneficiaries fall due ("pay-as-you-go funding").¹

The PBGC's historical policy has been full funding of new claims and the amortization of the unfunded portion of past claims over a fixed period. Views concerning the proper amortization period have changed over time. As the program's deficit has grown, there has been a tendency toward longer amortization, in an effort to keep the annual premium as low as possible. The premium increase request submitted in 1982 recommended 5-year amortization. By 1985, the period had lengthened to 15 years.

However premiums are set, they inevitably need adjustment. ERISA currently makes premium adjustment an ad hoc process requiring the approval of Congress. While the initial increase in 1977 was quickly approved, the history of the subsequent increase, which was proposed in 1982 and came to fruition in 1986, illustrates how lengthy the legislative process can be. Compounding this problem are the volatility and unpredictability of the insurance program's revenue needs (discussed in Chapter III), which suggest that premium levels may have to be adjusted frequently.

The alternatives to requiring congressional approval of every premium revision are delegating the task to some other body or establishing rules for automatically adjusting premiums to reflect

the program's experience. Some commentators have urged the former alternative,² but it is not examined here because the pertinent considerations are almost entirely political. The other alternative, automatic adjustment rules, offers the prospect of responsiveness to changing conditions without any surrender by Congress of its ultimate control over premium policy.

The PBGC's Funding Policy

The PBGC has traditionally advocated different funding policies for new claims and for unfunded old claims. The former are to be funded at once, the latter to be amortized over 5 to 15 years. Corporation officials have consistently rejected a pay-as-you-go policy for either stratum of claims. Pay-as-you-go is at the same time the alternative policy most often proposed by critics who believe that PBGC premium requests are unduly high.

The immediate attraction of pay-as-you-go is a sizable decrease in the insurance program's short-term revenue requirements. For fiscal year 1988, the premium required to balance the program's cash flow would be about \$1.38 per participant, far less than what is required by any other funding policy. (This calculation assumes that \$27 million in assets (the equivalent of \$10.22 per participant) are acquired from plans and sponsors of plans terminate in that year.)

Compensating for this short-run benefit is the cost of higher premiums later on. Because pay-as-you-go minimizes investment income, more premium dollars must be collected in the long haul than under alternative schemes. From the premium payer's point of view, this feature is not necessarily undesirable. Firms retain the use of their funds for a longer period, generating extra investment returns that should at least offset the higher premiums ultimately paid.

The flaw in the pay-as-you-go principle is that there is no way to keep the payers from going out of the system. The continuation of pension plans is voluntary. If pay-as-you-go were instituted, firms could pay low premiums for a few years, then terminate their plans when rates became too high, leaving the insurance program with a smaller premium base and a need for yet higher rates, which would prompt yet more terminations. The higher premiums would also discourage new plan formations, so that the premium base could only erode.

To avoid this sequence, a pay-as-you-go funding policy would have to be accompanied by legal changes that would inhibit the termination of PBGC-insured plans. Any such changes, whether in the form of a ban on termination or an "exit tax" (analogous to the "withdrawal liability" currently imposed on companies that

leave underfunded multiemployer pension plans), would be a major change in the principles underlying pension law.

Two issues are involved in amortizing the deficit: first, the amortization method that will be used and, second, the number of years over which the debt will be retired.

Conventional amortization, which has been embodied in all of the PBGC's past premium requests, provides for level annual payments. The real value of these payments does not remain constant, however. If the value of the dollar declines, the earlier installments will be larger, in constant dollars, than the later ones. (In the event of deflation, the reverse will occur.) The nominally equal installments are, then, not really equal, and the effect of conventional amortization (so long as inflation continues) is to accelerate the rate at which the real value of the deficit is paid off.

In lieu of conventional amortization, it is possible to construct a schedule where installments are indexed to some measure of changes in the value of the dollar.⁴ The real value of each installment, adjusted for inflation or deflation, would then remain constant. In nominal terms, the installments would increase or decrease, but they would not change in value and would be no more or less burdensome at the end of the amortization period than at the beginning.

Conventional amortization has the virtues of simplicity and predictability, but, given the size of the insurance program's current deficit, the implicit "bunching" of amortization in the next few years may be unattractive. To amortize the present deficit over 15 years would require annual installments of \$398 million (at a 7.25 percent interest rate), or about \$12.20 per participant in fiscal year 1988. By the end of the 1988 amortization period, the real value of this nominal amount can reasonably be expected to be much less (\$4.90 per participant (1987 dollars) in 2002, assuming a 6.25 percent annual increase and no change in the number of participants).

Real value amortization spreads inflation-adjusted costs more evenly over whatever period has been selected. It requires, however, making assumptions about what future inflation will be. If these prove inaccurate, the scheme will retire the deficit over a longer or shorter period than anticipated. (Alternatively, the premium could increase based on the assumed rate regardless of what happened. This might cause the burden in real terms to change significantly.) In extreme cases, where inflation is much lower than anticipated, the deficit may climb in real terms.

There are no hard and fast principles for selecting the length of the amortization period. If the conventional method is used, there is little point in considering periods of longer than 15 years, because early payments retire very little principal and

lengthening the schedule does not markedly reduce the amount of each payment. For example, the annual payment required to amortize \$1,000 over 15 years at 7.25 percent interest is \$104.00. Doubling the amortization period to 30 years reduces the annual payment by only 26 percent, to \$77.03.

In real value amortization, lengthening the period has a more substantial impact on the initial nominal premium, owing to the compounding effect of assumed future inflation. The initial payment for 15-year amortization of \$1,000 at 7.25 percent, assuming 4 percent inflation, would be \$81.96. For 30-year amortization, the initial installment drops to \$50.28, a 39 percent decrease.

Rules for Adjusting Premiums

For the reasons discussed in Chapters III and IV, it might be advisable to set rules for the automatic adjustment of the insurance program's premiums in order to obviate delays between changes in its financial condition and their reflection in the premium schedule. The purpose of an automatic adjustment mechanism is to revise the premium schedule regularly to minimize the discrepancy between actual program revenues and the amounts required by whatever funding policy has been adopted.

A number of factors may make premium revision necessary. Any structure will require adjustment if the amount of revenue that needs to be raised varies from what was projected. This can result from higher or lower claims or administrative expenses than expected or from increases or decreases in the deficit. However, for a flat-rate, per capita premium, changes are otherwise needed only if the number of participants varies from what was anticipated. Under a variable-rate premium, other factors affecting the rate base can also change.

The possible adjustment formulae vary greatly in both complexity and effects. There are several types of rules that can be adopted, listed here in order of increasing complexity:

1. A "funding target" can be set for the program, based on some ratio such as assets to the value of liabilities or assets to benefit payments. So long as the ratio is below target, premiums would increase each year by a predetermined amount. If the ratio rose above the target, premiums would decrease.
2. The premium can be adjusted so as to amortize, over a specified period, deviations from the projections on which the original premium level was based. The projections too may be adjusted as time goes on.

3. The premium for each year can be set at the level necessary to fund all claims incurred in the preceding year (or, more feasibly, the second preceding year) in accordance with the funding policy for new claims. Under this approach, the deficit that existed when the adjustment mechanism was adopted would be "frozen"; in principle, no new unfunded claims or other deviations from experience would be assumed to accumulate.

Many variations on these themes are possible. For example, adjustments may be made less often than annually, there may be different amortization periods for different types of experience gain and loss, or the extent to which premiums are allowed to rise from one year to the next may be limited.

As the general approaches increase in complexity, they also increase in responsiveness, with the third approximating, as nearly as practicable, the results that would be achieved if each year's experience were known in advance and premiums were set accordingly. This approach will thus do the best job of adhering to the established funding policy. The others will, in practice, deviate from the funding policy, but there is no reason to expect that the variation will be so large as to undermine the policy's goals.

Designing a Cost-Related Premium Structure

The most straightforward way to overhaul the premium structure is to begin by segregating the program's costs and analyzing how these can be rationally related to the prices that plans pay for coverage. The premise is that the premium that a plan pays should be proportionate to the costs for which it is "responsible." This principle underlies most rate-setting by private insurance companies, which try to avoid cross-subsidies by equating cost and price for each group of insureds with comparable pertinent characteristics.

In the context of the PBGC insurance program, this principle means that covered plans that have manifested a similar potential for presenting claims should, as a group, share the burden of the actual claims and other costs associated with their coverage. Thus if plans with characteristic x are responsible for y percent of net claims, they should be charged y percent of the total premiums needed to fund net claims. Applying this principle concretely requires answering a number of questions:

* Which costs of the insurance program should be funded on a risk-related basis, and which are more appropriately funded through a flat-rate premium?

* What plan, sponsor or other factors should be reflected in the premium rates?

* What base should the premium rates should be applied to, and how that base should be measured?

* What modifications to the basic structure are needed to prevent the premiums charged to particular plans from becoming so burdensome as to be, in and of themselves, a cause of plan termination?

Nature of Program Costs

The costs of the PBGC insurance program fall into three distinct and dissimilar categories:

Current year net claims: the present value of the unfunded guaranteed benefits of plans terminated in the current year (net of any collections of employer liability or due and unpaid contributions).

Administrative expenses: the costs of operating the insurance program.

Amortization of accumulated surplus or deficit: the amount needed to amortize (over some specified period) past claims that were not funded when incurred, past premium collections in excess of costs and changes in the present value of past claims resulting from interest rate fluctuations, investment performance, and other sources of experience gains and losses.

A variable-rate premium may be appropriate for funding some of these costs and inappropriate for others. Net claims are a strong candidate for "risk-related" funding. Some plans are more likely than others to give rise to net claims, and these differences in the probability of a claim can be associated with plan and sponsor characteristics, making it possible to allocate premiums in accordance with cost.

The program's administrative expenses, by contrast, are not readily allocable on the basis of risk or exposure. The major costs include the collection of premiums, management, general administrative functions, processing of terminations that do not present claims, policy development and the like, none of which can plausibly be attributed to specific plans or classes of plan.

The proper way to fund the third category of program cost -- the amortization of the unfunded portion of past claims -- is less clearcut. As claims recede into the past, their relationship to current premium payers grows somewhat tenuous, and they can be looked upon as "overhead" that should not be allocated on a

"risk-related" basis. Some part of this cost could, however, rationally be covered by the risk-related component.

Rate Base for Risk-Related Premiums

Two fundamental elements enter into the calculation of any risk-related premium: the amount of the insured's potential claim and a charge per unit of exposure. The latter will vary with the characteristics of the insured. For example, the potential claim presented by a term life insurance policy is the face amount of the policy, while the charge per unit of exposure is based on the insurer's estimate of the likelihood that a particular insured will die during the term of the policy.

The PBGC's insurance policies have no fixed face amounts or limits on the insurer's liability. The potential claim with respect to a particular insured plan is the value of its unfunded PBGC-guaranteed benefits at plan termination, reduced by the value of collectible employer liability. Hence, the "natural" unit of exposure for the PBGC's purposes is \$x of net unfunded guaranteed benefits. Unfunded guaranteed benefits are not, however, calculated routinely by ongoing plans and are not really knowable until and unless the plan terminates. Some proxy unit of exposure— is therefore needed.

The best available basis for estimating potential claims appears to be unfunded vested benefits, which all defined benefit plans must value at least triennially and report on Form 5500 (Form 5500-C for plans with fewer than 100 participants), Schedule B. Vested benefits are closely related to guaranteed benefits; on average, 85 to 90 percent of a terminated plan's vested benefits are guaranteed, although there are wide variations. The value of a plan's unfunded vested benefits should therefore approximate the value of its unfunded guaranteed benefits.

It is not practical to adjust the exposure base that is used to estimate exposure for possible recoveries of employer liability. Virtually all post-SEPPAA claims will arise from plans whose sponsors are bankrupt or, at least, in serious financial trouble, so that the amount of employer liability collected in the future can be expected to be very low (as was the case in the past). If it is considered desirable to charge lower premiums to financially strong employers, the reduction can be accomplished directly by relating premium rates to sponsor characteristics, as discussed in the next part of this appendix.

Plan, Sponsor, and Industry Characteristics

In addition to exposure, many advocates of premium reform argue that premium setting should take into account other factors that affect the likelihood that a plan will give rise to claims against the insurance program. Among the candidates for premium rating factors are the plan's funded ratio, the financial strength of its sponsor and the health of the industry in which the sponsor operates.

Plan Funded Ratios

The PBGC insurance program has existed for only 12 years and has processed fewer than 1,400 claims. Such limited experience provides little basis for definitive judgments about how plan characteristics are related to expected claims. Nevertheless, low funded ratios appear to be linked to a high probability of termination, probably because troubled sponsors have strong motives to divert cash into their businesses and away from their pension plans.

Using data on terminated plans and a sample of ongoing plans, a 1983 PBGC staff study calculated the ratios between the percentage of net claims attributable to plans with specified funded levels and the percentage of premiums paid by those plans. A one-to-one ratio would indicate that a class of plans was "paying its way," that is, generating revenue to cover the full costs for which it was responsible.

The study found that plans that were poorly funded three years prior to termination generated disproportionately large insurance claims and that the claims-to-premiums ratio increased substantially as the percentage of funded benefits decreased. This is not a very surprising result, although, in the absence of more extensive statistical testing, it should not be taken as "proving" that a plan's risk of termination is a function of its funded ratio.

Sponsor Characteristics

The use of plan funding as a factor in determining risk-related premiums is straightforward. The introduction of sponsor characteristics, on the other hand, presents a number of problems. Not only is it difficult to compare one firm's financial statements to another's, but acceptable financial ratios vary widely from industry to industry. There are no simple, readily available indicators of financial health that would not create serious anomalies. More complex formulae might not cure the anomalies and would make calculating and collecting premiums more cumbersome and expensive. (See Chapter III for a discussion of the reliability of bankruptcy indicators.)

The specter of a PBGC bureaucracy "rating" thousands of companies has long been an objection to changing from a flat rate premium. There are, however, strong reasons why sponsor health should not be a rating factor, even if measuring it were a less formidable task. Businesses do not have regular or predictable "life cycles"; current success is no guarantee of future prosperity. Moreover, when a firm does collapse, its decline is often precipitous. Hence, there is no known way to compile reliable "actuarial statistics" for plan sponsors. The most that can be said is that firms on the verge of bankruptcy are likely to fail and that the future of the rest is unpredictable.

Industry Characteristics

Because claims against the PBGC insurance program have been concentrated heavily in a few industries, it has been suggested that premiums should vary from one industry to another, just as medical insurance costs, for instance, are higher for companies operating in industries with greater health risks.

There are two objections to this approach. First, many plans cover workers in more than one industry. It is not clear how premiums should logically be apportioned in such cases. Second and more fundamentally, a scheme that charged higher premiums to all firms in, say, the steel industry would allocate some of the costs of poorly funded plans to companies whose plans were well-funded, thus reintroducing some of the perverse incentives that a risk-related premium is intended to correct. For these reasons, the classification of plans by industry is probably inappropriate for PBGC premium purposes.

Constraints on a "Variable-Rate" Premium Structure

The design of a new premium structure should not ignore practical constraints. Some of these have already been noted in passing (e.g., the PBGC's inability to rate plan sponsors' financial strength on an individualized basis). Others are discussed here.

Calculating Exposure on a Comparable Basis

Although all PBGC-insured plans are required to calculate unfunded vested benefits at least triennially and to report them on their annual reports, the reported figures are not comparable, due to the use of varying actuarial assumptions. The most significant difference arises from the wide range of interest rates used to value benefits. The annual report does not include enough information to enable the PBGC to convert reported liabilities to standardized values on an individual plan basis and could not reasonably be made sufficient for this purpose.

There are several possible ways to obtain comparable valuations of plan liabilities. The most precise would be to require plans to conduct additional valuations based on uniform, PBGC-prescribed assumptions. If the plan valuation were entirely computerized, an additional valuation would be only a minor burden, but the vast majority of PBGC-insured plans are small or medium-sized (more than 90 percent have 500 or fewer participants), and their valuations are frequently carried out wholly or partly "by hand."

An alternative to valuation on the basis of uniform assumptions is the conversion of reported liabilities to standardized values by the use of "rules of thumb." One can calculate what effect a change of x percent in the valuation interest rate would have on the value of benefits for a plan with a "typical" distribution of liabilities by age, then use this calculation to estimate standardized values for all plans. This method may misvalue the liabilities of particular plans but should give usable aggregate results for all plans except those with highly unusual demographics.

Limits on Premiums Charged to Particular Plans

Some plans have large unfunded vested benefits and are very bad risks by any standard. Private insurers deal with the worst risks by denying coverage, a recourse that is not available to the PBGC. Therefore, it is necessary to decide whether a risk-related premium structure should "let the chips fall where they may," possibly charging some plans so much that they are virtually forced to terminate, or should be modified by a "cap" on the amount to be paid by any particular plan.

At first glance, premium caps violate the basic principle of relating price to cost and to reintroduce a subsidy element into the insurance program. The argument for a premium cap does not, however, rest on a desire to assist weak sponsors. Rather, the cap follows naturally, in at least some circumstances, from the nature of the program. Because the shift to a variable-rate premium structure would constitute a major change for plan sponsors, the transition period should afford sponsors ample time and opportunity to adjust to the new structure.

Thus, the PBGC chose a structure such that the premium charged to the riskiest plans should not be so high as to make their continuation prohibitively expensive. The level at which this cap should be set cannot be determined a priori. (When and if a risk-related premium is adopted, the facts existing at that time will have to be analyzed in order to find a level that will be low enough not to affect materially the probability of termination yet high enough to be consistent with the goals of the new structure.)

Volatility of Premium Rates and Revenue

One virtue of the current premium structure is that plan sponsors can accurately predict what they will pay in future years and the PBGC can accurately forecast its revenue. Some of this predictability results from the fact that premium rates have been adjusted only twice in 12 years, but, even when this factor is taken into account, risk-related premiums could be more volatile than those charged under the current structure.

For plan sponsors, there are three reasons why premium charges may vary from year to year: changes in the premium schedule, changes in exposure and changes in other factors that are used in premium calculations. The second and third of these do not present real problems. Changes in exposure tend to be reasonably foreseeable, while changes in factors that indicate risk of termination clearly ought to lead to commensurate changes in premium assessments. Sharp and unpredictable changes in the premium schedule, on the other hand, could become an irritant to plan sponsors. Therefore, any mechanism for automatically adjusting premiums should attempt to "smooth" the impact of large year-to-year variations in the insurance program's financial condition.

Revenue volatility is not a problem *per se* for the insurance program. Indeed, to the extent that the program's funding policy attempts to match annual revenues to net claims, volatility is desirable. It is troublesome only if revenues consistently fall short of the amount needed to meet the funding policy's goals. Although such shortfalls are possible, they would not immediately threaten the program's ability to meet its commitments, and the adjustment mechanism, if well designed, would eventually make up the deficiency. A serious danger of insolvency would arise only if the program's assets were allowed to fall dangerously below current levels.

Small Plans

The PBGC insures about 110,000 pension plans, of which about 65,000 have 25 or fewer participants and about 90,000 have 100 or fewer. But this great multitude accounts for only a little over 5 percent of the 30 million participants in covered plans and an even smaller fraction of net claims.

By their numbers alone, small plans could be an inordinate problem for any premium structure more complicated than the present one. Furthermore, their benefit valuations are the least likely to be useful for premium assessment purposes. Not only is it common for small plans to be valued less often than once a year, but standardization of their reported liability values is exceptionally difficult. Small populations may be widely different, simply as the result of chance, from those used to

construct standard conversion factors, and it is not feasible to require tiny plans to perform additional valuations solely for use in premium calculations.

For these reasons, plans with fewer than 100 participants should ~~probably~~ be excluded from any variable-~~rate~~-premium structure.

NOTES -- APPENDIX B

¹ A third "pole" would be the creation of a reserve for claims that might be incurred in future years. This alternative has not been examined, because the current state of the insurance program's finances renders it unrealistic.

² Vincent Amoroso, "How To Fund the PBGC," Pensions & Investment Age, December 9, 1985, p.53.

³ We have excluded from consideration the extreme variant of pay-as-you-go, which would have the PBGC cannibalize all of its current assets before levying premiums. This scheme would require no premiums at all for several years.

⁴ Given the nature of the PBGC insurance program, an appropriate index would be nominal wage growth. A premium that remained constant, as measured by this index, would represent a constant percentage of payroll for a "typical" employer and thus, even if it rose in nominal terms, should not provide a motive for terminating PBGC-insured plans.

⁵ Throughout this appendix, the term "risk-related" will be used for any premium that is based on plan or sponsor characteristics other than the number of participants in the plan. Strictly speaking, not all of these characteristics are related to "risk," i.e., to the probability that the plan will terminate with a claim against the insurance program. For example, a premium that varies only with the gross amount of a plan's underfunding is probably better described as "exposure-related" than "risk-related," but it would be cumbersome to make this distinction everywhere that it might be pertinent. In its recommendations to the Congress, the PBGC proposes adopting a variant of the risk-related premium called the variable-rate premium.

⁶ ERISA requires valuations only once every 3 years. Annual valuations are routine for large plans but become less common as the number of participants decreases.

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APR - 6 1987

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Los Angeles Times

Federal Insurer Cuts Red Tape for Many Caught in Catch 22 Situation

Agency Settles Landmark Pensions Case

By JONATHAN PETERSON, Times Staff Writer

APR 2 1987

When Lidz Bros. Inc. went out of business in 1978, Saverio Ramputi got no pension, despite his 35 years of service at the New York firm that specialized in importing and exporting buttons.

Ramputi shared a problem with thousands of workers and retirees at other companies which cancelled their pension programs in the late 1970s. The federal agency created to insure the pensions didn't fully cover them—if the plans had been modified within five years of the plans' termination.

In a situation fraught with bureaucratic irony, many such pension programs had been forced to change in order to meet

higher federal standards designed to protect the beneficiaries. Yet the result of the new requirements was a smaller pension, or none at all, if such a firm went belly up or ended its pension program.

Ramputi, who had joined the family-owned button firm as an errand boy in the 1940s, sued the agency, the Pension Benefit Guaranty Corp. And this week, in a decision that could affect more than 16,000 workers and retirees, the PBGC decided to settle with Ramputi and with workers at Midvale-Heppenstall, a defunct Philadelphia steel company.

"Out of an overriding concern for the participants' welfare, the PBGC has made

the difficult decision to settle the case," said Kathleen P. Utgoff, the agency's executive director. "The decision will place added responsibility on the PBGC at a time of already increased workload. But it's our job to protect the retirement income of American workers, and nothing is more important."

Under the agreement, those workers who have lost out because their plans had been changed to comply with the tougher federal requirements and then terminated between 1976 and 1981, would get 65% of the benefits they lost, as well as interest.

Ramputi, who would receive \$300 a

Please see PENSION, Page 3

MARKETS AT A GLANCE

INSIDE

PENSION: Landmark Case Settled by Agency

(Continued from Page 1)

month and also a one-time payment of \$15,000 or more if the settlement gets court approval, as expected, said he was ecstatic. "I just wanted to see that justice was done," he said from his home in Las Vegas.

PBGC officials estimated that at least 14,000 workers and retirees would benefit. In addition, the agency will review 21,000 pension plans to look for other individuals who would might gain as a result of the agreement.

The quasi-governmental corporation is funded by contributions from private pension plans.

Ramputi's attorney, Mark A. Bornstein, said about 10,000 workers and retirees at 311 defunct pension plans had already been identified. Their new benefits would be worth \$28 million.

The number of beneficiaries could ultimately reach 20,000 to 30,000, with the added value of benefits possibly as high as \$61 million, he said.

Bornstein added that most of the beneficiaries would get their payments automatically. "They don't have to file a claim. They don't have to prove an entitlement."

The controversy dates back to the birth of PBGC in 1974, as part of landmark federal legislation to safeguard private pension benefits. To protect the finances of the fledgling agency, which is supported by private employers, Congress said it didn't have to fully insure benefits for workers whose companies went bankrupt within five years after changing their plans.

Yet many of the companies that went out of business—and terminated their retirement plans—were pulled down in part by the more stringent pension-financing requirements.

WHEELING-PITTSBURGH STEEL CORP. (Pittsburgh) — Richard E. Stoll was named interim chief operating officer. He is vice president and general manager,

Staubenville Profit Center, which is the flagship of this beleaguered steel manufacturing concern, which filed for bankruptcy-law protection from its creditors two years ago. J.M. Little, an attorney in Houston, was named interim secretary and general counsel.

The appointments came after the resignations of John D. Fry, president and chief operating officer, and Francis P. Massco, vice president, secretary and general counsel. They resigned over salary disputes.

THE NEW YORK TIMES, MONDAY, APRIL 6, 1987

BUSINESS Digest

Pilots Offer \$4.5 Billion For United

By CALVIN SIMS

The pilots' union of United Airlines, which has been at odds with management for some time, made an offer yesterday to buy United from the Alleghis Corporation for \$4.5 billion in cash, subordinated notes and assumed debt.

The union said in a three-page letter addressed to Richard J. Ferris, the chairman and chief executive of Alleghis, that the company's stockholders would be best served by "a restructuring of the company which would separate the airline from the auto and hotel assets."

"United Airlines should be returned to its core businesses," the Airline Pilots' Master Executive Council said in the letter, which was signed by F.C. Dubinsky, chairman of the Airline Pilots Association Master Council.

No Comment by Company

A spokesman for the airline said late yesterday that it could not be immediately determined if the letter had been received and that the company could not yet comment.

A source in the financial community familiar with the situation said, however, that while the pilots were expected to be able to raise the money they had not yet done so.

Since a strike last year, the pilots' union and United's management have often been at odds on how to improve productivity and cut costs in order to make the giant airline competitive with such emerging low-cost carriers as the Texas Air Corporation, which owns Continental Airlines and

Continued on Page D4

THE NEW YORK TIMES, MONDAY, APRIL 6, 1987

Pilots Bid \$4.5 Billion for United Air

Continued From First Business Page
Eastern Airlines.

In the letter, which was dated yesterday, Mr. Dubinsky said the union was making the offer as a result of rumors that United might be a potential takeover target.

Unlike other carriers, such as Trans World Airlines, which had heavy losses and which was taken over by Carl C. Icahn, the New York investor, with the help of two major T.W.A. unions, United is strong financially despite some problems, and thus less vulnerable to takeover efforts.

Also, in the case of T.W.A., the desire of the unions to prevent a takeover by Frank Lorenzo, the chairman of Texas Air, helped unite the unions in support of Mr. Icahn. The unions also offered wage and benefit concessions, which Mr. Icahn used to help persuade T.W.A.'s board to approve his takeover bid.

In the United case, there is no such outside takeover threat at this time, and the pilots' union, in its letter, did not offer major concessions in support of its offer. Instead, it said that expected wage, pension and productivity savings by the pilots after they

United is strong financially despite some problems.

took over the airline would total about \$300 million a year.

The bid of the pilots is expected to have a difficult time since they are pursuing a financially strong company, and there was no indication in the letter that the effort was being supported by other unions at United at this time.

The pilots said that their financial adviser was Lazard Frères & Company and that the union and the investment banker were "prepared to discuss all aspects of this proposal with you and commence negotiations immediately."

Allegis, under the leadership of Mr. Ferris, has diversified rapidly, acquiring the Hertz Corporation. It also has Hilton International, a major hotel chain that will be added to Allegis's existing hotel business, Westin Hotel and Resorts.

As the corporation has diversified, Mr. Ferris has emphasized that each unit will have to largely finance its own growth, and that one should not subsidize the other. This has raised concern among airline employees and union leaders that the airline, which has had some setbacks in its earnings, may not get the commitment from management to finance its growth.

The pilots, in their letter, said that in "today's highly competitive industry environment, a first-class airline cannot afford the drain of financial capital and corporate commitment that results from excessive diversification."

"In our view," the letter added, "an airline should not be operated as part of a diversified enterprise."

The offer is for all United equipment, the carrier's computerized

reservations system — one of the largest and most sophisticated in the airline industry — and all the landing and gate rights currently held by United.

No Per-Share Value

Because the \$4.5 billion offer is being made for United Airlines and not the holding company, analysts declined to put a per-share value on the offer. Allegis has 57 million shares outstanding. At the close of business on Friday, Allegis's shares were trading at \$93 each on the New York Stock Exchange.

John Pincavage, an analyst with Paine Webber, said that there has been a "tremendous amount of dissatisfaction and friction between the pilots and Allegis management." Tensions have been compounded in recent weeks as the pilots suspected that management would ask for more concessions to meet the growing low-cost competition in the industry.

Mr. Pincavage added that, although there was no indication of financing, the pilots could raise the financing if they followed the same formula Mr. Icahn used to take over T.W.A., mainly through the refinancing of airplanes and related equipment and an employee stock ownership plan.

Air Atlanta Seeks Chapter 11 Protection, Signaling Almost Certain End of Carrier

By LINDA WILLIAMS

Staff Reporter of THE WALL STREET JOURNAL
ATLANTA—Air Atlanta Inc. filed for protection under Chapter 11 of the federal Bankruptcy Code, a move that signals the almost certain end of the three-year-old carrier.

The company said in a statement that it "temporarily discontinued" scheduled weekend service Friday and expected to resume limited scheduled service today. However, a senior executive said that scenario was highly unlikely.

The company finally began bankruptcy-law proceedings, according to the executive, because after two weeks of desperate negotiations for a capital infusion, such aid didn't appear to be forthcoming. He said Air Atlanta has no cash on hand and is unlikely to get the credit needed to resume flying its seven-jet fleet.

Under Chapter 11, a company is allowed to continue operating while it develops a plan to repay creditors.

The closely held concern's approximately 650 employees were furloughed Friday, a spokeswoman said. The company hasn't yet determined how many employees would be called back. If it resumes operations, or what kind of limited service would be offered, she added.

Creditors' Influence

There's still a slim chance that Air Atlanta may be revived, according to sources familiar with the company. The Chapter 11 filing gives greater influence to creditors, the largest of which is Equitable Life Assurance Society of the U.S., and they could conceivably pump cash into the company to resume operations under new management.

But, the sources added, a reconstituted Air Atlanta wouldn't likely include Michael R. Hollis, the 33-year-old lawyer who in 1984 launched the airline. Operating out of its Atlanta hub, it eventually served nine cities. From the start the airline catered to the business traveler, offering roomy seats, tasty meals and a gate-side lounge with free drinks, telephones and newspapers.

As a young, black entrepreneur in a high-profile business, Mr. Hollis drew much attention to Air Atlanta. And his wealth of contacts helped him draw investors. Former Atlanta Mayor Maynard

Jackson is on the board and the city's current mayor, Andrew Young, made introductions to KLM Royal Dutch Airlines, which recently had been in talks for a joint marketing agreement.

But investors eventually became uneasy at Mr. Hollis's inability to keep a president and chief operating officer at the company. Mr. Hollis, chairman and chief executive officer, had no prior airline experience, and it was felt that a strong operations manager was needed. The investors' unease was a leading factor in their unwillingness, finally, to plow more money into Air Atlanta.

Last-Ditch Effort

Sources said that in a last-ditch effort to keep from closing down, Mr. Hollis and the entire board offered to resign if Equitable would invest an additional \$10 million in the company. The company recently had been negotiating to sell as much as a 25% stake to KLM that would include an agreement for Air Atlanta to feed passengers to KLM international flights. But KLM ultimately was unwilling to strike the agreement without one of the other investors chipping in at least \$10 million more to Air Atlanta. None would.

Equitable won't comment on the specifics of its relationship with the carrier. But in a statement Friday, the big insurer said, "Our investment in Air Atlanta was made after a careful consideration of its value, acknowledging, however, the risk involved in a start-up venture of this kind."

It is regrettable that Air Atlanta didn't succeed. But in no way does the outcome reflect the hard work of Air Atlanta's management team and employees."

Equitable provided \$35 million of Air Atlanta's some \$90 million total capitalization, most of which was debt. Other significant investors included Aetna Life & Casualty Co., which provided about \$8 million, and the railroad concern CSX Corp., which provided about \$8.5 million in exchange for Air Atlanta providing exclusive jet service to its Greenbrier resort near Lewisburg, W.Va.

The company has estimated assets of about \$40 million, including leased aircraft

and landing slots at various airports. It currently has about \$50 million of debt outstanding, mostly in the form of zero-coupon convertible notes. Debt outstanding also includes some \$3 million to \$5 million owed to vendors such as Atlanta's Hartsfield International Airport, which is owed about \$300,000 in rent and landing fees.

Air Atlanta was considered the best-financed minority venture ever. Still, it was undercapitalized for entering the airline industry at a time when deregulation brought cutthroat competition. In that sense, it was no different from other minority-led ventures that are almost always undercapitalized and particularly weak in attracting equity capital, said Edward

Irons, an Atlanta University finance professor.

Operating with a limited capital base, the company had losses of some \$40 million and had to appeal constantly for bailouts. Meanwhile, three chief operating officers came and went—including some who had serious philosophical and personality differences with Mr. Hollis. That didn't bolster investors' confidence in an operation that needed an estimated \$50 million to \$60 million to get on its feet. Some industry sources said it would have taken millions more to sustain a profit and produce a return on investment.

Asked if he thought investors let the company down, Air Atlanta executive vice

president Daniel Kolber said: "They were good guys and bad guys. But at least they played. They danced with you even though they may have stepped on your toes."

USAir Traffic Increases 17.2%

ARLINGTON, Va.—USAir Group Inc. said its USAir unit flew 1.10 billion revenue passenger miles in March, up 17.2% from 942.6 million miles a year earlier.

The figure set a single-month record for the company. A revenue passenger mile is one paying passenger flown one mile.

The company said its load factor, or the percentage of seats filled, rose to 66.5% from 62.9% a year earlier.

Government watch/

MINNEAPOLIS STAR TRIBUNE

MINNEAPOLIS, MN
DAILY 378,981MONDAY
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212

BURRLETT'S

The health of America's private pension plans, and the government program that guarantees those plans should they fail, is causing some furrowed brows in Congress these days.

In the first of a series of reports about the private pension system, the General Accounting Office says that more than 3,300 plans — each with a membership of 100 or more employees — are underfunded by approximately \$21 billion. While the underfunded plans account for only about one-fourth of the total number of private programs in the country, their increasing liabilities could be dangerous.

In 1974, Congress created an insurance program for pension plans to be administered by the Employee Benefit Guaranty Corp. When a plan is terminated with fewer assets than liabilities, the corporation becomes its trustee and pays the benefits. The corporation, in turn, is funded by premiums paid by active pension plans.

From 1974 through fiscal 1985, about 1,100 underfunded plans were terminated. Claims against those plans have exceeded the corporation's premium income by about \$1.3 billion.

"Based on our analyses," says the GAO, "we conclude that the contingent liability to the Pension Benefit Guaranty Corp. insurance program is significant and growing. Considering the insurance fund's current deficit, we believe that the program could be in jeopardy if the recent trend in the termination of plans with large amounts of unfunded benefits continues."

GAO reports on underfunded pensions

**From Washington**

David Phelps

Plank testifies on takeovers

Some of the nation's top corporate executives told the Senate Banking Committee last week that legislation is needed now to curb hostile takeover abuses.

The executives asked the committee, chaired by Sen. William Proxmire, D-Wis., to lengthen the tender-offer period from 20 days to 90 days so a potential takeover company can consider other bids. They also asked for tighter public disclosure requirements so raiders can be detected sooner. In addition, the corporate leaders asked for the outlawing of "greenmail," a practice in which a company pays a premium price to buy back stock held by an unwanted suitor.

Among the witnesses appearing before the committee was Raymond Plank, chairman of Apache, Corp., the Twin Cities-based oil-production company. Plank, a founder of an anti-takeover group known as Stakeholders in America, said the Justice Department and the Securities and Exchange Commission must enforce existing antitrust and disclosure laws

more vigorously. Plank also said raiders should be required to file economic-impact statements regarding their intentions for a business.

"Please don't stop with insider reprimands," Plank told the committee. "Let the raider and defender forego greenmail. Don't let the practiced raider get by with the assertion his first hit is for investment purposes. Close the loophole of the shareholder-stamping two-tier or series tender (where those who take the first offer get a better deal). Require the

hit man to file an impact statement of his game plan on employees, their retirement funds, upon the communities, customers, suppliers and debt holders lest assets be stripped and constituencies robbed."

Proxmire cancels votes

When Sen. William Proxmire, chairman of the Senate Banking Committee, schedules a vote these days on bank legislation, industry lobbyists are likely to only pencil it into their appointment books.

Twice in two weeks the Wisconsin Democrat has set a time and date for voting on his bill, which would raise funds for the Federal Savings and Loan Insurance Corp., freeze the number of limited-service banks, allow the interstate purchase of failing banks and limit the hold on check deposits. Both times Proxmire has canceled the meeting, apparently because he lacks the votes to pass the legislation.

A third vote is scheduled for Tuesday, but it is unclear if Proxmire has found the votes. If he hasn't, he may have to settle for a scaled-back bill that only raises funds for the Federal Savings and Loan Insurance Corp.

NEWSDAY

LONG ISLAND, NY
SUNDAY 666,951

MAR 15 1987

5630 **BURRELLE'S**

MONEY WATCH

Early Retirement: Take It or Leave It?

IN AN EFFORT to cut labor costs and increase competitiveness, many companies are making their senior executives and workers an offer they hope won't be refused: early retirement.

Two weeks ago, for example, Doubleday & Co., which was acquired in December by the German publishing conglomerate Bertelsmann AG, offered an early retirement option to its 4,000 employees in Manhattan and Garden City. In September, 10,000 IBM employees took up the computer giant's offer for early leave.

"There's no question that companies are trying to be more efficient today," said Donald Underwood, a vice president and pension analyst with Merrill Lynch. "Virtually all the automotive manufacturers have instituted early retirement plans to streamline themselves. All the oil companies have early retirement plans. I can't think of any computer company that isn't doing it."

Early retirement plans targeted to older workers come in a variety of shapes and sizes. Most offer a strong monetary incentive to leave, usually a pension enhancement ranging from a half-year to two years' salary on top of the pension payout that would accrue to the worker based on age and experience. The pension sweetener can be given in a lump sum or, more often, over time until Social Security benefits begin coming in.

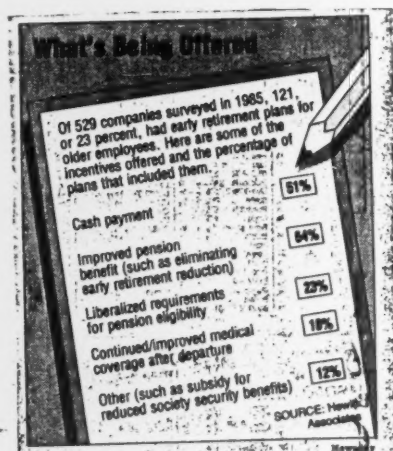
Should a worker take the early retirement escape hatch? Pension experts advise eligible employees to ask themselves the following questions:

● How much do you need? The first thing a worker should do when faced with a retirement offer is figure out how much money is needed to support himself after retirement, said Michael Kresh of Tecum Financial Services in Hicksville.

As a rule, a total retirement plan, including interest income from personal assets, should annually pay 60 percent to 80 percent of your income to maintain your pre-retirement lifestyle, Kresh said. A person who retires at 65 can hit the 60 percent to 80 percent mark through a combination of full company pension payments and Social Security payments.

But if a worker retires early, at age 55, with partial pension payments, he'll need additional income until Social Security payments kick in. Where will the extra money come from? Unless the employee intends to work part time or full time after retirement, the Social Security margin will have to be met entirely by the company's early retirement plan.

"One of the things you have to look at is how the early retirement plan compares with staying on to retirement age," said Kresh, adding that the top Social Security payment for a married 65-year-old who retires this year is \$1,273 a month. "Let's say somebody is earning \$40,000 a year in pay, and their normal pension is 50 percent of their salary. If this person retires at 65, he gets a \$20,000 pension and \$15,000 a year in Social Security, for a total of \$35,000. That's a good deal. But suppose under an early retirement option our \$40,000-a-year worker left at age 55 and got a reduced pension of \$15,000 a year, with no Social Security for ten years. Well,



METALWORKING NEWS

NEW YORK, NY
WEEKLY

MAR 9 1987

BURRELL'S

-7683

A-C Restructuring Plan Involves Sale of Most Operating Units

By LAURI GIESSEN

MILWAUKEE—Allis-Chalmers Corp. is proposing a restructuring plan that would involve the sale of all the firm's operating units except those associated with its American Air Filter Co., a move which could alter the structure of an earlier proposed spin-off of its international business and crushing equipment operations.

Although a spokesman said the firm expects to continue with earlier plans to spin off Svedala Allis AB, to be headquartered in Malmo, Sweden (MN, Feb. 16), he added that the make-up of that unit may be different than previously described.

"It's too early yet to tell how it will look, but there are some changes in the structure of that unit being contemplated," he said.

The spokesman said it could not be determined if other units that A-C now hopes to sell off might be added to the

spin-off company. A-C has said it hoped to retain some interest in the spin-off, as well as generate cash through selling shares to outside investors. The firm has not said what percentage it expects to retain.

The latest restructuring proposal was presented last week to institutional lenders, union representatives, the Pension Benefit Guaranty Corp., and others. Proceeds from the sale of units and from a public financing of over \$100 million are expected to be used to pay a portion of the company's outstanding debt.

It appears that the units for sale will be those in pyroprocessing equipment, minerals processing equipment and systems, waste decontamination services and services for upgrading power generation.

The earlier plan was to spin off Allis-Chalmers' subsidiaries in Europe, Latin America, Asia and Australia, as well as
(Continued on page 16)

(Continued from page 5)

the domestic crushing and screening business that markets to aggregate, mining and mineral processing businesses.

The air filter business to be retained appears to be one of the firm's more profitable units. Although the firm has not yet broken down its 1986 sales and earnings into the various divisions, the air filter business in 1985 had annual sales of \$285 million and a pretax income of \$17 million.

Eli Lustgarten, a vice president with Paine, Webber, Jackson & Curtis, New York, said it was too early to determine whether A-C would be viable after the restructuring is completed. He said the air filter business appears profitable, but much of the firm's fate appears tied to its ability to lower its long-term debt from funds obtained through the sale of units. Lustgarten was uncertain as to the value and marketability of those units.

The restructuring plan also provides for payment of health benefits for active and retired employees at a substantially reduced level, with benefits for retirees

being paid from dedicated funding, reductions in fixed costs through restructuring of operations and the elimination of substantially all of the firm's existing debt other than working capital financing utilized subsequent to the closing of the restructuring.

The plan is subject to approval of the firm's creditors and stockholders and to its reaching an agreement with present and former employees.

The company said earlier this month it expected to have to ask for another deferral on its long-term debt payment due April 30. A-C had been able to get deferral of payments due in November and December of 1986 and January of 1987. The firm also in recent months has complained that its health care costs were too large for a company its size.

A-C has been hampered by debts and obligations from when it was a major producer of agricultural and construction equipment. It sold off its interest in Fiat-Allis, a construction equipment maker, and sold its agricultural equipment operations in 1985 to Klockner-Humboldt-Deutz AG of West Germany.

HERALD

WESTMINSTER, CA
WEEKLY 2,400

MAR 12 1987

BURRELLE'S

NEWS WITH VIEWS

By: Del Carron
MPT

SOVIET MANNED SPACE STATION — Was resupplied by the Russians highly successful progress series. This one, the 26th, also carried a small manufacturing plant to manufacture crystals in space.

CALIF. WATER SUPPLY — That depends on snow runoff from the Sierra Nevada Mountains is down by one half the normal snow pack and Calif. water supply will be down by 50 percent — Look for water use restrictions.

G.A.O. — Or as it is known at the U.S. General Accounting Office is stating that the Federal Savings and Loan Insurance Corp., which insures deposits at Federal Thrift institutions is now in a deficit status and is insolvent. This is in conflict with the Federal Home Loan Board report of 1.9 billion on hand Dec. 1986.

BUT AMERICAN AND FLY U.S. Planes — Is getting more and more important each day as American airlines leases 20 Airbus made in foreign countries and also Japan's Nippon airlines will buy 20 Airbus planes. This industry coupled with an expected 40 percent of U.S. auto sales to foreign makers will cost the United States over 400,000 jobs.

THE RUN IS ON — And some U.S. banks are shaking in their vaults. Nigeria is the latest to withhold payment. Did not pay 24 million due Jan. 1986 and has issued "promise to pay notes" since 1983 on their 18.5 billion debt. Brazil is not paying on its 100 billion debt. Argentina with its 3.45 billion debt is stalling. So is the Philippines who owes 8.6 billion and Ecuador who owes 8.1 is also slowly stopping its payments and Mexico who owes over 100 million along with Chile with 14.8 billion and Venezuela who has 30 billion dollars in foreign debt, all are in the middle of rescheduling their debt payments and few are making payments in full during negotiations. Be prudent with your banking operations. Ask questions.

JOB LOSS — Totaling 406,000 jobs occurred between Sept. 1984 and Aug. 1986 and are in the high paying manufacturing field, factory jobs — there have been service type jobs created in this time frame but they only pay minimum wages.

PAKISTAN — Who is being wooed by Russia was told by the Soviets that they would take up to three years to get out of

Afghanistan and nothing less.

OFFICE OF MANUFACTURE AND BUDGET — Directed by James Miller, has said that Reagan Administration will not support an import fee on imported oil. OMs, which most often is against anything to build strength of nation, and against new ideas to make America stronger, is suspect as to whose side it is on. Its actions and recommendation to Congress and to the press, it seems it is definitely not in best interests of USA.

SIZED — Companies in trouble due to management and foreign dumping of steel. Has dumped another \$2-billion in pension debt to U.S. agency, the Pension Benefits Guaranty Corp. which is already 2-bill. in deficit. Bethlehem and Kaiser expected to do same.

UNFROZEN DINNERS — Right off the shelf lasagna, beef stroganoff, others are pre-cooked and vacuum sealed, rope into microwave and ready in 2-minutes.

LATIN AMERICA — In troubled times, being unable to repay foreign debts is snaking up Japan who holds 13% of one-trillion dollars.

GOOD MANAGEMENT IDEAS — It raids its GMAC financial subsidiary and then consolidates, the GM debt would mount to about 64 billion.

OIL PRICES — Staying at about \$16 per barrel if earthquake damage to Nigeria is not too bad. Oil firms will hike prices at pump.

NET WORTH — Or gross worth as gross national product was 4-trillion dollars last year or each American's share — \$17,400.

MOROCCO — Talking to U.S., it owes 18 billion in foreign debt and wants more help. King Hassan II made a pact with Libya but that will slide into the sunset as USA and Morocco get together on their 300th anniversary of their treaty of friendship.

SOUTH YEMEN — Leased to Russia its naval base on Isle of Socotra in Arabian Sea. S. Yemen in midst of internal trouble that may make this Saudi Arabian neighbor more peaceful.

AUSTRALIA — Regardless of what the TV tourist ads say, that country is in deepest trouble of its life. The 18 million peopled country is almost broke, has union troubles and outdated commercial laws holding it back.

GM IN TROUBLE — Where is the money to buy the 20% of shares coming from? Not from car sales which is down.

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MAR 20 1987

BURRELLES

Union decries postponement of LTV pension suit

2197 P 1000
By Nicholas Knezevich

The Pittsburgh Press

A bankruptcy court judge's delay of a United Steelworkers' suit to force LTV Steel Co. to restore a \$400 monthly pension supplement to 8,000 early retirees is "a disgrace," the union says.

Judge Burton Lifland, of New York District Bankruptcy Court, yesterday postponed until May 4 testimony on the union's suit. He had earlier postponed a hearing from Feb. 27.

Both postponements were requested by the federal Pension Benefit Guaranty Corp., which on Jan. 12 terminated LTV's underfunded pension system and

assumed payments of up to \$1,850 per month to retirees.

Tony Rainaldi, chief USW negotiator at LTV, said Lifland's "refusal to act was a gross denial of due process."

"There is just no excuse for the judge to have caved in to the PBGC while people are suffering financial losses," he said.

Lifland told the union the delay would permit the federal agency and LTV to negotiate a settlement.

"The process of negotiation... ought to be given full opportunity to work itself out," Lifland said. "It seems to me we have a golden opportunity to fashion an accommodation."

"That's outrageous," Rainaldi complained. He said the

two sides are already negotiating, and accused the PBGC of "trying to dictate to the company what it can and cannot settle with us."

The PBGC argued that the retirees are one group of creditors among many and that the extra pension payments — which could amount to between \$30 million and \$40 million a year — would reduce assets available to pay off LTV's other debts.

While the PBGC insures basic pensions, it does not cover supplements, known as "sweeteners," that are paid until a retiree qualifies for Social Security at age 62.

The union argues that the loss of the \$400 supplement is a violation of the union's contract.

Please see LTV, B8

LTV

from page B8

Many early retirees left when their jobs were abolished and receive basic benefits of no more than \$200 per month, the union said. Denial of the supplement is creating an "undue hardship," the union said.

The irony is that the union was the prime mover in passing the law that created the PBGC. But under the Reagan administration, this instrument of the people has been turned into a monster," Rainaldi said.

Disgruntled USW pensioners and non-union retirees have been picketing LTV plant sites for weeks, trying to force the company's hand or to encourage workers to strike.

Salaried workers who accepted early retirement in some cases have lost a larger slice of their benefits than union members. The PBGC calculates benefit payments on age. (United Press International contributed to this report.)

MACHINIST

WASHINGTON, DC
MONTHLY \$60,000

MAR 1987

BUREAU

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Reagan acts to grab pensions

President Reagan, who enjoys a whopping pension from the State of California and another from Social Security, is planning sweeping changes in the federal pension law. If he gets away with this move, his friends, the employers, will find it even easier to take surplus money out of pension funds and use it for their own benefit.

"This is the most outrageously brazen action the President has taken since he tried to abolish Social Security," commented one pension expert in Washington, DC.

"Congress is going to take a hard look at the whole issue of who has rights to pension money," said Phyllis Borzi, a pension counsel for the House Labor Management Relations Subcommittee. "This money was put aside for retirement. It is really deferred compensation (to the workers). It is not the company's (money)."

Reagan is making his move now because the high interest rates of a few years ago and the still continuing rise of the stock market have bloated many pension plans.

Reagan wants to give more "flexibility" to his corporate friends so they can raid their employees' plan and reap the benefits of the pension windfall.

At this writing, the Administration has not made its bid, but secret documents uncovered by the *New York Times* from the White House, the Labor Department and the Internal Revenue Service give the details for the pension grab.

His move also comes at a time when the IAM and other public interest organizations including consumer groups are trying to strengthen pension laws to give more protection to workers.

Even under existing laws, big companies like United Airlines, Firestone, Texaco and American Express have already skimmed off more than \$12 billion from overfunded pension funds.

Reagan's scheme, which already has been endorsed by his Economic Policy Council, would open the door to even more pension skimming.

Reagan says his proposal to help employers raid their workers' pension plans would help the employers to "find more productive uses" for the money.

These uses would include buying out competitors and other companies in the same manner that energy companies used windfall profits from deregulation to buy other companies. Some of these funds would also be used to help companies move overseas for cheaper labor.

Reagan's proposal would also allow companies to shift money from one plan to another. If, for example, the company wanted to move money from its plan covering its union workers to its plan covering management employees, the Reagan proposal would say that was all right.

To counter Reagan's scheme, the IAM is pushing for legislation



that will more fully protect members and their families by banning employer withdrawals or penalizing companies who try such skimming techniques.

The IAM is also pushing for adequate funding of the Pension Benefit Guaranty Corporation, the semi-governmental body that was set up to insure that workers still get their pension when their employers file for bankruptcy or otherwise go out of business to escape their obligations.

DALLAS MORNING NEWS

DALLAS, TX
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BURRELL'S

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LTV, creditors reach tentative settlement

By Ruth Shereff
Special to The News

NEW YORK — A dispute about how LTV Corp. should allocate assets and liabilities among its subsidiaries has been tentatively settled "after three days of hectic discussions and negotiations" involving the Dallas-based holding company, its major creditors, lending banks and the federal pension insurance agency, a lawyer for LTV said Friday.

Michael J. Crammes refused to disclose any details when he announced the proposed settlement at a hearing in U.S. Bankruptcy Court for the Southern District of New York.

But he told Judge Burton Lifland that the agreement would resolve the objections that the Committee of Unsecured Creditors and Pension Benefit Guaranty Corp. had regarding a \$100 million credit line a group of banks offered LTV in December.

As part of the agreement, LTV will file for some changes in its traditional cash management system, Crammes said. Under the system, cash is consolidated daily at parent LTV Corp., then disbursed to meet the needs of its various affiliates. Lifland allowed the system to continue when LTV and more than 65 subsidiaries filed for protection under Chapter 11

of the U.S. bankruptcy code in July.

The wording of the agreement still is being worked out, but it will be filed in time for a hearing scheduled for March 17 at 2 p.m., Crammes said.

The Committee of Unsecured Creditors and the pension agency had objected to the terms of the new \$100 million loan, saying it gave the banks an advantage in claims on the company's assets.

In exchange for the new credit line and an extension of existing loans of about \$300 million each to LTV Steel Co. and LTV Sales Finance Inc., the parent company originally had agreed to limit the

transfer of profits from LTV's aerospace and defense operations to ailing subsidiaries.

The creditors committee complained there was no corresponding provision for limiting the flow of funds from the steel unit, which has been generating cash in recent months.

Creditors of individual subsidiaries also objected to terms of the loan that made one subsidiary liable for the debt of another. One person close to the negotiations said the agreement might be limited to requiring the company to notify creditors before cash or obligations are switched from one affiliate to another. 2

Laws of our land are ironic

A recent article published in the Indianapolis Star featured the views of Walter Williams of Heritage Features Syndicate. The viewpoints expressed were that of fraud, lies and trickery as he dealt with the many deceptions of the Social Security system.

The shortcomings of pensions does not end with the inadequacies of the Social Security system. Also at odds with the established rules of integrity are the promises made in private pension agreements. The 15-, 30- and 40-year funding standards of defined benefit plan liabilities is a complete travesty. The long-term liabilities of such plans are afforded the liberal requirements of federal laws on only a minimum basis. Private-sector pension contracts are only as secure as the plan sponsor intends them to be.

And to further enhance the shallow funding requirements of poorly funded pension plans, the federal government allows a written guarantee to pay the benefits of an underfunded plan which has been terminated. The Employee

Retirement Income Security Act of 1974 established the Pension Benefit Guaranty Corp., an agency that insures benefits of defaulted pension plans. PBGC has as its directional criteria a set of unpublished inhouse rules which delays, deducts or denies benefits of even the weakest of pension agreements.

Because of the excessive liabilities of already terminated pension plans, PBGC cannot guarantee the payment of benefits to future participants of terminated plans. PBGC cannot pay long-term obligations of present retirees under the present circumstances. The termination of another major pension plan with substantial underfundings could not be covered by the already financially distressed agency. Nevertheless, PBGC still extracts the insurance premiums from employers to insure the underfundings of their plans in case of termination.

It remains more than a bit ironic that the laws of our land will uphold the verbal promise of

marriage as a breachable offense of society and protects people from fraudulent schemes, but when the laws are applied to pension matters, they become void. The promise of payment for services rendered can be upheld in the courts as a breach for a failure to comply, but declare that same agreement a part of a pension contract and the promise becomes meaningless. The words of a prudent man become worthless and the protections against fraud become unenforceable. The laws of a civilized society are not bound by the contractual agreements of a prudent man as his words are used to defraud working class Americans on matters of pension security.

P.L. Kauble
Kokomo, Ind.

KOKOMO TRIBUNE

KOKOMO, IN
DAILY 27,704

WEDNESDAY
MAR 16 1987

BURRELLE'S

147

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BURRELLE'S

Judge delays LTV hearing

U.S. Bankruptcy Judge Burton Lifland refused yesterday to act on a United Steelworkers' lawsuit that seeks to reinstate \$400-a-month retirement supplements to about 7,000 LTV Steel Co. retirees. The New York judge, at the request of the Pension Benefit Guaranty Corp., delayed until May 4 proceedings originally scheduled to have been heard on Feb 27. It was the second delay granted by Lifland. Anthony Rainaldi, the union's chief LTV negotiator, accused the court of "trampling" on workers' legal rights. The PBGC, a quasi-government agency, earlier this year assumed LTV's underfunded pension obligations. Some retirees have had their incomes cut by more than 50 percent.



VARIABLE-RATE PREMIUM: A FACT SHEET

OVERVIEW: The Pension Benefit Guaranty Corporation (PBGC), the Federal agency that insures the retirement income of nearly 30 million Americans in single-employer plans, is supported by premiums charged to the 110,000 pension plans that are insured. The premium rate, initially \$1.00 per participant per year in 1974, was increased by the Congress to \$2.60 in 1977 and to \$8.50 in 1986. As a result of larger, more poorly funded plan terminations, premium revenues are not sufficient to cover program costs and the PBGC faces a deficit of nearly \$4 billion.

Instead of another increase in the flat-rate premium, the Administration has proposed a new premium structure to increase revenues and at the same time make the premium payers more accountable for their own plans' funding status. The new premium would keep the PBGC single-employer program solvent by funding new net claims of about \$600 million per year (in constant dollars) as these claims are incurred and by eliminating the PBGC's deficit over the next 30 years. The new premium rates would be effective for plan years beginning in 1988.

HIGHLIGHTS: The proposal would provide:

Adequate revenue for the pension insurance program's needs. The new premium structure would raise enough revenue both to cover anticipated claims and retire the program's deficit over a period of time.

Equitable allocation of premium charges. Plans that present the greatest risk and exposure to the PBGC's insurance program would pay the highest premiums. Plans that present little risk would pay a lesser premium covering the program's administrative expenses and retirement of the accumulated deficit.

Reasonable premium amount. For about 92 percent of the plans, which comprise two-thirds of the participants insured by the PBGC, the premium rate would remain the same. For all plans, premiums would remain a small percentage of an employer's overall payroll and benefit expenses per employee. A maximum limit on the premium would prevent unreasonable burdens.

Incentives for adequate plan funding. Plans that present a higher risk because of funding waivers or unpaid contributions would be subject to a funding surcharge on their premiums as an incentive to encourage employers to maintain adequately funded plans. The surcharge would not be subject to the maximum limit.

PROPOSED PROVISIONS:

- Premium:** All employers with insured defined benefit plans would pay the same \$8.50 per-participant premium rate that is currently charged, indexed to wage increases.
- o For plans covering fewer than 100 participants, or funded at or above the specified funding target of 125 percent of the present value of vested benefits, employers would pay only the \$8.50 rate.
 - o For plans covering 100 or more participants, employers would pay the \$8.50 rate plus an additional funding charge of \$6.00 per \$1,000 of underfunding below 125 percent of the present value of vested benefits. The funding charge would not apply to benefits for which an employer provides the PBGC with adequate security, or for which an insurance company annuity contract has been purchased.
 - o Premium calculations would be simple, requiring no more information than is already compiled (on Form 5500) by plans for their own use, with liabilities standardized to the PBGC's closeout interest rate.
 - o The total premium would be subject to a maximum limitation, set at \$100.00 per participant and indexed to 1.5 times wage increases. For example, if wages increase 5 percent, the maximum limitation would increase 7.5 percent. It is estimated that less than 5 percent of all plans would be affected by the maximum limit.

Triennial

- Review:** The funding charge would be reviewed once every three years in order to reduce premiums when the program's experience is more favorable than anticipated or increase premiums when experience is worse than anticipated. This triennial adjustment--based upon actual claims experience, the PBGC's deficit, the number of insured participants, and plan underfunding--is intended to assure that the pension insurance program remains solvent and does not deteriorate to a point from which it cannot recover financially.
- o The funding charge, only, would be increased or decreased by no more than 50 percent as a result of the triennial review.
 - o Including the funding charge adjustment, the total premium would not rise above the \$100.00 per participant (indexed) cap as a result of a triennial review.

Surcharge: If, subsequent to enactment of the variable-rate premium, a required contribution to a plan is waived or not paid when due, the employer would pay an additional charge to compensate for the additional risk inherent in the unpaid contribution and to

provide an incentive for adequate funding of the pension plan. Surcharges would go into effect in 1989.

- o The surcharge, which would be a percentage of the additional funding charge due for the plan, would not be subject to the maximum limit of \$100.00 per participant.
- o For funding waivers, the surcharge would be 50 percent the first year, 40 percent the second year, 30 percent the third year, and would continue to decrease until it is completely phased out at the end of five years. Older waivers and those that have been repaid would not result in a surcharge.
- o For funding deficiencies, the surcharge would be 50 percent for each plan year that a plan's funding deficiency has increased or would increase if a pending waiver request is denied. This surcharge is applied for five years, or until the unpaid amount is paid in full, whichever is earlier.
- o Any funding surcharge would be doubled for plans that pay subsidized benefits on plant shutdown or in other situations if such payment would significantly increase vested benefit liabilities.

Premium

Liability: The sponsor and its controlled group would be liable for the premiums. Under current law, premiums are liabilities of the plan and increased premiums simply increase plan underfunding or may result in benefit losses to participants. Since responsibility for plan funding ultimately lies with the entire controlled group maintaining the plan, this is where the responsibility for payment of premiums also would be placed.

Prepared by: Pension Benefit Guaranty Corporation
Communications and Public Affairs Department
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NEWS

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FOR IMMEDIATE RELEASE

April 6, 1987

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ADMINISTRATION PROPOSES PBGC'S VARIABLE-RATE PREMIUM LEGISLATION

In legislation submitted to the Congress today, the Administration has proposed a variable-rate premium to maintain the solvency of the Pension Benefit Guaranty Corporation (PBGC) insurance program, Executive Director Kathleen P. Utgoff announced.

"The proposed premium will raise additional revenue so that the PBGC can continue to insure the retirement security of workers and retirees. It will also provide incentives to increase plan funding and reduce the likelihood that well-funded plans will leave the defined benefit pension system," Dr. Utgoff explained.

The new premium rates, which would be effective for plan years beginning in 1988, are expected to generate enough revenues to fund new losses averaging about \$600 million per year and to retire the PBGC's nearly \$4 billion deficit over the next 30 years.

The proposal would revise the PBGC's present flat-rate premium structure for 110,000 single-employer plans. For about 92 percent of the plans, which contain two-thirds of the participants insured under the single-employer program, the total premium rate would remain at the current \$8.50 per participant, indexed for wage growth.

Plan underfunding is the primary cause of the PBGC's mounting deficit and threatens pension security, as described in a study required by the Congress and also issued today. The premium proposal is intended to allocate greater premium responsibility to the underfunded plans that reflect the greatest risk to plan participants and the pension insurance program.

- more -

PBGC Add One

"This proposal will help assure that employers that responsibly fund their plans will shoulder a smaller share of program costs; those that rely upon subsidies from the pension insurance program and, indirectly, upon other employers whose premiums support the program will have to pay more. A premium cap will also assure that no company faces an intolerable burden," Dr. Utgoff added.

The proposal contains the following provisions:

PREMIUMS:

- o All employers with insured single-employer plans would pay \$8.50 per participant, indexed to wage increases.
- o For plans covering 100 or more participants that are funded below 125 percent of the present value of vested benefits, employers would pay an additional funding charge of \$6.00 per \$1,000 of underfunding. The funding charge would not apply to benefits for which an employer provides the PBGC with adequate security, or for which an insurance company annuity contract has been purchased.
- o The total premium would be subject to a maximum limitation, initially set at \$100 per participant and indexed to 1.5 times wage increases.

TRIENNIAL REVIEW:

- o The funding charge would be automatically adjusted upon review every three years to permit reduced premiums when the single-employer program's experience is more favorable than anticipated and increased premiums when experience is worse than anticipated.
- o The funding charge would be adjusted by no more than 50 percent as a result of this triennial review. Including the funding charge adjustment, the total premium would not rise above the \$100 per participant (indexed) cap as a result of a triennial review.

SURCHARGE:

- o If, subsequent to enactment of the variable-rate premium, a required contribution to a plan is waived or not paid when due, the employer would pay an additional charge, equal to a percentage of the funding charge due for the plan, to compensate for the additional risk inherent in the unpaid contribution.
- o The surcharges are additive, and are not subject to the \$100 per-participant maximum limitation on the premium.

PREMIUM LIABILITY:

- o The plan sponsor and its controlled group would be liable for the premiums.

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Chairman PICKLE. Dr. Utgoff, I thank you.

I will say again that you are showing a good attitude, you are trying to get something done. I like your statement, and it is very helpful to this committee.

You said at the beginning that if we do not do something soon, you will be dependent on liquidating assets to meet your monthly benefit obligation.

Ms. UTGOFF. That is right.

Chairman PICKLE. How soon do you think that will be?

Ms. UTGOFF. We have two funds. The fund which takes in assets from the underfunded plans is called the trust fund. We have a separate fund, the revolving fund, which takes in premiums and makes up for plan underfunding. The revolving fund probably will be out of money in 1989. And if plans that we take over continue to be about 40-percent funded and continue to have about 60 percent of their participants already retired, we expect to run completely out of money in 2003.

If, however, the trend continues where plans become more and more underfunded, and more of the participants are actually retired, it could be a good deal earlier than that. The date that we run out of money depends almost entirely on how well-funded future terminating plans are when we take them over and how many people are actually retired.

You can take over two plans that have the same amount of underfunding, but one has some cash in it, and it will have most of its participants deferred, so that insurance funds are not needed right away. However, a plan like Allis-Chalmers, which, when we took it over, had no money in it, and virtually everyone was immediately in pay status, requires the PBCG to begin immediately paying benefits with insurance funds.

So if we take over more plans like that, we will not last until 2000.

Chairman PICKLE. Let me ask for a resumé of your summary. I am trying to find out how soon must we make these changes, and you have given me one discussion that it might be the year 2003. If it is 2003, I think a lot of Members would say well, we will take that under consideration 4 or 5 years from now when we start looking at it. You do not mean that; it is more urgent than that.

Ms. UTGOFF. No, I do not mean that. That would be like asking when somebody who is hemorrhaging is going to run out of blood. You do not want to know how many quarts of blood they have left; you want to know how quickly you need to step in before they die.

If we wait until the PBGC is totally out of money, first of all what is likely to happen is we might not be able to put participants into pay status when they retire, because we might take in a plan that has more benefit obligations than we have money; and second, the premium that would be needed at that time, if you wait until the PBGC runs out of money, is going to be extravagant, and it will convince people to leave the system before we have to raise that money.

I am just saying that the "drop dead date" if things go on as they are is about 2000. But I am not recommending that we wait until that date, and anyway, you do not want to have a horizon where premiums are relatively low now, and then kick up by an enor-

mous amount in 10 or 15 years, because it is a bad planning horizon for plan sponsors.

Chairman PICKLE. What I am driving at is if we were to proceed as we are now, with an \$8.50 premium, and if we continued just relying on these assets from the trust fund, would we anticipate under normal economic conditions that you would be running out of money then, within 1 year or 2 years or 3 years?

Ms. UTGOFF. We will start using into the assets of the trust fund more rapidly in about one and a half years. Now, what those assets are are assets that have been set aside to pay benefits in the future, so we will be basically eating our seed corn if we do that. But we can do that and keep on going.

So in about another year and a half, in 1989, the revolving fund will be out of money, and our income will start exceeding our benefit payments.

Chairman PICKLE. All right. By 1989, you would have a negative cash flow. And if between now and 1989, you had one, two, or three more major companies fold, we would have a real problem, wouldn't we?

Ms. UTGOFF. Yes, we would have a severe problem.

Chairman PICKLE. Well, now, rather than go into the details of your program, let me just ask you an overall question. If we were to go to a variable-rate and—

Ms. UTGOFF. I understand. No. What happened a year ago today when SEPPAA was passed, is that you cannot any longer terminate an underfunded pension plan unless you qualify for distress conditions, which are basically conditions under which you can file for bankruptcy. Most of the cases that we see are bankruptcy cases.

No company is going to file for bankruptcy to avoid costs of \$100 per person. The legal costs of filing for bankruptcy are higher than that. We are not in a situation where \$100 is going to affect whether a company stays in an underfunded plan. But we will affect people who can leave the program very easily, and those are the sponsors of well-funded pension plans. It is difficult for an underfunded company to leave; you either have to put the money in, or you have to file for bankruptcy. We have 6,000 to 8,000 plan terminations a year of sufficiently-funded plans of well-funded companies. It is those plans that we are most worried about, to keep them in the system.

Chairman PICKLE. Well, your feeling is, then, that though your recommendations are progressive and even bold by some measurement, even so, the cap you put on of \$100 per participant is not so large that it would cause companies to cancel their plans, and you do not think, then, that there would be adverse effect, negative effect, if you went this route.

Ms. UTGOFF. No, no, I do not in any way. I think the effects would be positive on plan maintenance.

Chairman PICKLE. All right. Thank you.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Dr. Utgoff. The variable-rate premium proposal exempts plans with less than 100 participants from this funding charge. How many of the plans that have less than 100 partici-

pants and are underfunded have less than 125 percent of the present value of the vested benefits?

Ms. UTGOFF. About 80 percent of our plan sponsors, representing 6 percent of participants, represent companies with less than 100-plan participants.

Mr. SCHULZE. Have less than 100?

Ms. UTGOFF. Yes.

Mr. SCHULZE. And how about the funding—are they underfunded?

Ms. UTGOFF. It is less than one-third, because we know that they are on average better funded than larger plans. And we know for all plans, about one-third of all plans are funded at less than this 125-percent level, so for the smaller plans it is something less than one-third.

Mr. SCHULZE. All right. So 80 percent have less than 100 participants.

Ms. UTGOFF. Eighty percent of the plans have less than 100 participants, but they represent—

Mr. SCHULZE. And one-third of those would be considered underfunded.

Ms. UTGOFF. Less. I can get you the answer to that, but I know that it is less than a third.

Mr. SCHULZE. Because of this exemption, how much revenue will the PBGC forego?

Ms. UTGOFF. Well, by the same calculation that I gave you, small underfunded plans have roughly 2 percent of the participants. So it is not very much revenue.

Mr. SCHULZE. You think that it is a reasonable way to draw a line?

Ms. UTGOFF. We believe it is very reasonable. The additional calculation costs and the burden on plan sponsors is high relative to the additional revenue that it would generate.

Mr. SCHULZE. Dr. Utgoff, the problems the administration's proposal seeks to deal with in the case of underfunded plans occur mainly in loss corporations. And so, there has been a proposal suggested around the Capitol based on the fact that profitable corporations can deduct their pension contributions, but a loss corporation cannot deduct in effect its contribution, or cannot utilize it for tax reasons. The belief is that a profitable corporation has been contributing half, in effect, whereas an unprofitable or loss corporation is contributing 100 percent. There has been a proposal suggested that the contributions be made 50-percent refundable, so that you could credit NOLs against the contribution. This certainly would have revenue implications, but it would be a way that loss corporations could utilize tax credits and perhaps strengthen the system.

I do not know whether you are aware of this or whether you have given any thought to it. What are your feelings? Is it something we should look into, and is it a proposal that might have some merit.

Ms. UTGOFF. The use of NOLs particularly with respect to underfunded steel companies has been discussed in a number of ways, and certainly, we are evaluating that.

One hundred dollars per company here is really not a substantial amount of money. LTV, in the year before they terminated their pension plan, would have been at the maximum. They would have paid \$10 million. They lost \$3 billion in that year.

Mr. SCHULZE. They lost \$3 billion?

Ms. UTGOFF. Yes. So I do not believe that the premium here is significant in terms of the financial outcome of the company. But for other purposes, I know that NOLs are being discussed. There is something of the anomaly that you talk about, that healthy companies are being encouraged to take money out of their business and put it into their pension plan through the tax system, and the same does not apply for companies that are not making money, and I think that is certainly worth considering when you look at the entire package.

Mr. SCHULZE. Do you think that this would have the effect of levelling that playing field a little bit so that we would dampen the incentive to overfund?

Ms. UTGOFF. It depends upon how it all works out. Some people might say that that is just a way to have the Treasury help finance the PBGC. But you would have to sit down and look at all the implications of that.

Mr. SCHULZE. Yes. It seems to me that the protection of the employees should be our main focus. If it is \$10 million versus a \$3 billion loss, then I do not know whether that should be our prime concern. The long-range effect on the PBGC and the benefit to employees should be our focus.

So you are saying that you are presently considering or studying this type of an approach? Can we expect something?

Ms. UTGOFF. Well, frankly, not in the context of the premium. But we have been looking at a number of proposals that have come from several sources that involve the use of NOLs.

Mr. SCHULZE. OK. Let me ask two questions, then. Do you anticipate a more in-depth look at this type of proposal, and should we look into it in more depth if you are not going to? Or can we expect something from you?

Ms. UTGOFF. We will be happy to look into it and get back to you.

Mr. CHANDLER. Would the gentleman yield?

Mr. SCHULZE. I would be happy to yield.

Mr. CHANDLER. If I could suggest something in that context, it might be worth looking at the investment tax credit. I have heard that suggested also as a funding mechanism, but obviously a company with no profit cannot utilize it. There has been suggestion that perhaps they could use the investment tax credit as a mechanism for funding their contribution.

Ms. UTGOFF. Let me point out that we are talking about probably two things here. The administration has two proposals—one that would increase the minimum funding standards for companies and the other that would increase, for some companies that had financial problems, their premium. Of those two, the premium is really very small relative to the eventual impact of the increase in the minimum contributions after transition rules are used.

So that I suspect that the application of the NOLs and the ITCs would be more relevant to the additional contributions that might have to eventually be made under the—

Mr. SCHULZE. Rather than the additional premium.

Ms. UTGOFF. The premium—the premium, as I said, is not burdensome. We are talking about a company that might need to make, to keep its pension plan from becoming more underfunded, \$2,000 or \$3,000 in contributions per person per year.

Mr. SCHULZE. Thank you, Dr. Utgoff.

Mr. Flipppo.

Mr. FLIPPO. Thank you very much.

Dr. Utgoff, if an employer gives you a security interest in assets equal to the amount of the plan unfunding plus a cushion, then that plan would be exempt from the funding charge?

Ms. UTGOFF. Yes.

Mr. FLIPPO. Doesn't this run the risk of turning your organization into a kind of a corporate pawnshop, and shouldn't employers be forced to just make the contribution to the plan?

Ms. UTGOFF. We are talking about a situation where a company has substantial assets and they have an underfunded plan. Some of these companies may feel that they do not pose the same kind of risk that an unhealthy company does, because they have the assets in the company to back up the pension promise.

What we are suggesting is if they want to qualify for a lower premium without making contributions, that in fact they link those assets more formally to the pension underfunding. They can then qualify for a lower premium by reducing the unfunded amount through pledging employer assets.

We do not expect this to happen very often, because most companies will realize that paying \$6 per \$1,000 of underfunding is in fact much easier. But all we want to do is point out that if you do have the assets to back up the pension promises, and they are in the company rather than in the plan, we will accept that as security, but it has to be more formally attached.

I should like to point out that we have in a number of cases taken security. We take security for funding waivers; we take security for employer liability; we do not take security that does not have real value. We know how to do it.

I do not expect that to become a significant part of the proposal. It is just a safety valve.

Mr. FLIPPO. I guess we cannot get Treasury to take security in lieu of income taxes sometimes.

Have you conducted an analysis of these employers who would have their premiums raised to the maximum? Are they concentrated in any one industry or any region of the country?

Ms. UTGOFF. As you might expect, they are more likely to be in heavy basic industries, manufacturing industries and not so much region-concentrated as in industries that are troubled, because the basic nature of the current system is that it encourages companies when they get into trouble to underfund their pension plan.

So whatever today's industries are that are experiencing competitive pressures are more likely to have underfunded plans. Now, that is not always true; there are many companies that are in the same troubled industries that have well-funded pension plans, and there are nontroubled industries that have underfunded pension plans. So the correlation is not exact. You are just much more likely to find an underfunded pension plan in a troubled industry.

Tomorrow's troubled industries may be where we cannot even imagine now, and they will be the ones where underfunding is more concentrated later.

Mr. FLIPPO. Well, are you having any underfunding in, say, high-tech industries, as opposed to manufacturing? Where are the failures really coming from?

Ms. UTGOFF. Many high-tech industries, to begin with, do not have defined benefit pension plans because of the mobility in those industries. But in every industry, there are some companies that tend to be underfunded. This could be true in some of the high-tech industries that may have experienced recent trouble.

The industries that we are talking about are, of course, the ones that are more likely to have defined benefit pension plans, and the basic industries are more likely to have defined benefit plans. Heavy manufacturing industries are now the ones that are experiencing the most trouble, and so they are most likely—not totally—but more likely to have underfunded pension plans.

Mr. FLIPPO. Thank you.

Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Dr. Utgoff, I believe I am beginning to better understand some of the statistics. As you read it, one feels as though some of them do not fit. But I now fully understand that 80 percent of the plans have 100 or less in them, and that is only 6 percent of the participants, and only about a third of those, or about 2 percent of the participants, are in the underfunded category.

Ms. UTGOFF. At most.

Mr. THOMAS. That begins to explain why on your fact sheet you say that about 92 percent of the plans would not show a premium increase, which cover about two-thirds of the participants.

Ms. UTGOFF. Yes.

Mr. THOMAS. It is beginning to fit together, because I could not figure out how you could have such a low increase.

What you are saying is that there are a few folks with a large number of participants that are at risk. Is that what you are really saying?

Ms. UTGOFF. Yes. All of the underfunding is concentrated in a few plans that cover one-third of the participants PBGC insures.

Mr. THOMAS. How did it get that way?

Ms. UTGOFF. Well, some plans, as you know, were underfunded when ERISA was passed. Since ERISA was passed, the plans that were well-funded have gotten better-funded. But as some recent studies have shown, the underfunding, even in the face of enormous increases in equity values, has in some cases gotten worse, so that the amount of money that the PBGC needs to kick in when we take over a pension plan has increased. So it appears as if the incentives of the current system have caused underfunding to become a bigger problem.

Mr. THOMAS. Is there some advantage to being underfunded in the current plan?

Ms. UTGOFF. Well, let me review the history of Wheeling-Pittsburgh. A company in a highly competitive industry went basically 4 years without making contributions to the plan. That amounted to a substantial amount of money. At the time they filed for bank-

ruptcy, it became clear that paying back that four years of no contributions was going to be a heavy burden. They dumped the plans and then were able to go on and have a \$3 an hour cost advantage on their competitors in that industry, so that everybody who has seen what Wheeling-Pittsburgh has done has begun to look at the same alternative.

Mr. THOMAS. If we knew that some plans were underfunded in 1974 when we started with the dollar charge, my assumption is that if we went to \$2.60 in 1977, it was in part addressed at that problem?

Ms. UTGOFF. In 1977, the only change was a change in the premium. To correct the problem that I am talking about, you really have to change the incentives in the system. And an increase in the flat-rate premium does not do that.

Mr. THOMAS. Does the fund cover shutdown benefits of a company that goes out of business?

Ms. UTGOFF. Some shutdown benefits are covered. If the participant fully qualifies for a shutdown benefit before the plan is terminated, yes, they are covered. They represent a significant liability for the PBGC, and they basically can kick in overnight and are not prefunded. So that—

Mr. THOMAS. That was my concern. Hopefully, they are not predictable. It requires, then, an enormous adjustment in your funds. How do you anticipate covering these in the future when you cannot really predict them—just have enough money in there?

Ms. UTGOFF. Well, we have for the last 6 months had a team of very sophisticated actuaries from the private sector addressing this very question, and they have come to the conclusion that these benefits basically cannot be prefunded, and that they threaten the security of a normal retirement plan. And I think we really have to look at that problem.

Now, the administration's minimum proposal has language in it that says that it will address more appropriate funding of shutdown benefits.

Mr. THOMAS. Can you assign a percentage to the deficit problem that we are in now attributable to the shutdown benefit portion? Or was it just the underfunded plans that got us in trouble?

Ms. UTGOFF. No. Shutdown benefits alone have accounted for about 20 percent of our deficit.

Mr. THOMAS. So it is a significant portion.

Ms. UTGOFF. A very significant portion.

Mr. THOMAS. I have a couple more questions, but I want to hold on a while. I want to hear some of the other questions.

Chairman PICKLE. Let me recognize Mr. McGrath, and we will come back to you if you have other questions.

Mr. McGrath.

Mr. McGRATH. Thank you, Mr. Chairman.

I believe Mr. Thomas' questions have answered most of mine. Thank you for your testimony.

Chairman PICKLE. Mr. Chandler is with us this morning. We will be pleased to hear from you if you have any questions or any comments to make.

Mr. CHANDLER. Mr. Chairman, I appreciate that courtesy, and I would like to ask a couple questions, if I could.

Dr. Utgoff, I would like to say that I am very glad you are where you are. It is a tough job you have, and you do not have any good news for anyone right now, and it is not because of you or lack of trying.

Ms. UTGOFF. Thank you.

Mr. CHANDLER. Our deficit right now in PBGC, in your testimony, you say is \$3.8 billion.

Ms. UTGOFF. Yes.

Mr. CHANDLER. That is based on plan terminations to today; is that correct?

Ms. UTGOFF. Basically, yes. It was the end-of-the-year figures, but it included pending terminations such as LTV. So that is basically the same figure it is today.

Mr. CHANDLER. So if we have—and I think we expect—more plan terminations, certainly in the metals industry, that would be added to this \$3.8 billion.

Ms. UTGOFF. Additional terminations from steel would add to the deficit.

Mr. CHANDLER. If they occur.

Ms. UTGOFF. Yes.

Mr. CHANDLER. I believe it is conceded that they probably will.

Ms. UTGOFF. I think we have to prepare for that.

Mr. CHANDLER. Do you have any thought of what might be done to prevent the obligations of those plans from becoming an obligation of PBGC—those plans that have not yet terminated?

Ms. UTGOFF. Under current law, there is very little that can be done, because they are so grossly underfunded. These plans represent a significant ongoing future responsibility for the companies, and in bankruptcy, the current law allows a company to discharge that debt.

Mr. CHANDLER. And that, it is my understanding, is because they can declare chapter 11 bankruptcy and continue in operation. The declaration of chapter 11 bankruptcy becomes the insurable event; the obligation is transferred, then, to the PBGC. Is that analysis correct under current law?

Ms. UTGOFF. Yes, in essence.

Mr. CHANDLER. Now, if the Congress in adopting the measure before us changes the insurable event from chapter 11 to chapter 7, would that solve or would it contribute to the solution of this problem?

Ms. UTGOFF. Right now, without other proposals, it is not clear that it would be helpful. If a company went first into chapter 11 and then chapter 7, the other creditors would get everything, and there would be nothing left for the PBGC.

We do not want to be the last person to try to go after a company's assets. So in theory, with other reforms, to make sure that that does not happen, it is not a bad idea, but right now, alone, that might not be very helpful.

Mr. CHANDLER. So in terms of jurisdiction, we would have to get the Judiciary Committee involved as well.

Ms. UTGOFF. It may not be Judiciary. One of the things would be to make sure that funding did not deteriorate, and that certain amounts would be priority claims. I am not sure, but it is not a

simple solution. Just going from chapter 11 to chapter 7 may not work.

Mr. CHANDLER. Mr. Chairman, if I may, one further question. This document was just released, so I do not know if you have had a chance to see it or not. It is the report of the Joint Committee on Taxation to the chairman's subcommittee on this issue. It points out on page 14 that a plan can actually be underfunded upon termination, yet prior to termination would be considered adequately funded. But termination brings about this underfunding because the time required for amortization of its liabilities has expired.

Ms. UTGOFF. Yes.

Mr. CHANDLER. Do you feel that that fact creates the necessity of a change in minimum funding standards for plans?

Ms. UTGOFF. That fact and many others. I think there is no doubt that the minimum funding standards must be changed if this system is ever going to be stable.

As I said, we have taken over—the Allis-Chalmers plant is another example of this. When we took over the Allis-Chalmers plan, it was 3-percent funded for guaranteed benefits, yet they were in complete compliance with the minimum funding standards.

Both the Kaiser and LTV cases, the salaried plans had no money, none at all; when we were forced to step in when they ran totally out of money, they were in complete compliance with the minimum funding standards. They had no waivers. They had characteristics of those plans which allowed them to continue to accrue benefits without making anything near the contribution that was required to keep the plan from deteriorating rapidly. The Allis-Chalmers plan deteriorated very, very rapidly.

Mr. CHANDLER. Mr. Chairman, I want to thank you for the opportunity to ask these questions today.

Thank you, Ms. Utgoff.

Ms. UTGOFF. Thank you.

Chairman PICKLE. Mr. Thomas, the Chair would recognize you further if you have additional questions.

Mr. THOMAS. Just briefly, if you can use the Allis-Chalmers or another example which would provide us with a better example of the details. Were most of these benefits, or virtually all of them, negotiated through collective-bargaining agreements?

Ms. UTGOFF. That is right.

Mr. THOMAS. My assumption is that the unions which negotiated these plans would be reviewing the plans to determine whether or not they received what was anticipated in terms of a dollar amount and to see if the company was living up to the agreement.

You say they deteriorated rapidly—so rapidly that the people who were monitoring them were not aware of the direction in which they were moving and the rapidity of that movement?

Ms. UTGOFF. Well, actually, it is pretty clear they were monitoring them, and they behaved according to the incentives of the current system.

Before ERISA was passed, unions had a strong incentive not only in the promise, but also in the funding behind the promise. In 1982, when it was clear that Allis-Chalmers was in severe trouble and that the plan might be terminated, the unions cut back on contributions in the collective-bargaining agreement. They had a collec-

tive-bargaining agreement that called for more than minimum contributions. In 1982 when the plan was clearly not going to pay anything more than guaranteed, they cut back contributions to the minimum level and got a credit for the past year and cut the contributions back to zero.

So it was clear it was being monitored, but it was a dangerous kind of monitoring.

Mr. THOMAS. Thank you very much.

Thank you, Mr. Chairman.

Chairman PICKLE. Ms. Utgoff, I want to thank you again. I want to say that I think Treasury and the PBGC have come forth with some positive considerations, and this committee is going to try to take them under consideration quickly and try to respond quickly with such recommendations we may think possible.

Now, I take it that in making your recommendations, you and Treasury, that while you have set figures such as less than \$100 and less than 125 percent of vested benefits, and the flat rate—all these figures are just what you think are the best approach and they are subject to possible changes and would have some variations in them.

Ms. UTGOFF. Yes.

Chairman PICKLE. For instance, we could consider raising the premium some, no matter whether you go from the present level up to a higher level. But there could be some changes in our figures, and you are not set on any set amount, except the general thrust and approach?

Ms. UTGOFF. The general thrust, but also that it raises the needed revenue. When you lower the minimum or the maximum or change any of those things, it does have a big impact on the revenue. And what we have done is tried to balance a number of factors. We believe that under the proposal, there is a reasonable distribution of premiums, a reasonable burden of distribution, and that with a good deal of assurance, within a wide range of claims, we can tell you that we are not going to be back here. And I think that is fairly important.

Chairman PICKLE. Now, may I ask you a broader question for just your general comment. Do you know of any group who might oppose the suggested changes? Does labor accept them? Do the employers, the manufacturers, accept them? Is there governmental opposition or acceptance of the general program? Have you had any one group that says this would be entirely wrong?

Ms. UTGOFF. Well, yes. I think that, first of all, employees and employers of plans that would pay more under a variable rate than under a flat rate are likely to oppose it. There are some people who—and I do not want to speak for them—who believe that the current subsidy program is appropriate, and that that was what Congress intended. And I think that that is the issue you have to address.

So it is not an employer—

Chairman PICKLE. Well, I can understand that. I guess what I am trying to drive at—does labor in general not dislike or object to the program, and on the other hand does the ERIC organization accept it or think it is appropriate?

Ms. UTGOFF. I think that more—without prejudging their testimony, and I have talked with all of them in the last couple of weeks—and I believe that more of the labor organizations that will testify today will oppose it than will favor it, and that the business community reaction will be generally supportive but mixed.

That is my preliminary estimate.

Chairman PICKLE. Well, we will see.

Ms. UTGOFF. Okay.

Chairman PICKLE. Again, thank you very much, Ms. Utgoff.

Ms. UTGOFF. Thank you. Let me know how I did.

Chairman PICKLE. The next panel will be composed of Nancy Gordon, who is the Assistant Director for Human Resources and Community Development, representing the CBO office. Is it Mrs. Gordon, Ms. Gordon?

Ms. GORDON. Whatever you would prefer.

Chairman PICKLE. The other panelist is Mr. Joseph Delfico, Senior Associate Director, Human Resources Division, representing the General Accounting Office. So we have the CBO and the GAO, and we will hear from the CBO first.

Mrs. Gordon.

STATEMENT OF NANCY M. GORDON, PH.D., ASSISTANT DIRECTOR, HUMAN RESOURCES AND COMMUNITY DEVELOPMENT DIVISION, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY BRUCE VAVRICHEK, DEPUTY ASSISTANT DIRECTOR, EDUCATION, EMPLOYMENT, HOUSING AND COMMUNITY DEVELOPMENT

Ms. GORDON. Thank you, Mr. Chairman. I am accompanied today by my Deputy, Bruce Vavrichek, who is seated to my left. I would also like to request that my written statement be included in the record, and I will just summarize it this morning.

Chairman PICKLE. We will have your entire statement included in the record. We are glad to have you here also. Both your statements will be put in in their entirety.

Now, proceed.

Ms. GORDON. I would like to start by describing figure 1 on page 5 of my statement which shows the accumulated deficit of the Pension Benefit Guaranty Corporation (PBGC). It has increased during all but 2 years since the program began reaching a level of \$3.8 billion by the end of 1986.

Chairman PICKLE. Page 5?

Ms. GORDON. Page 5.

Ignoring potential future claims, the Congressional Budget Office (CBO) estimates that the accumulated deficit could be repaid with a one-time charge of about \$120 per insured participant.

As shown in table 1 on page 6, a large part of the dollar value of claims against the PBGC has been made by an exceedingly small number of plans. For example, of the 1,350 underfunded pension plans terminating since 1975, the eight plans with the largest levels of unfunded benefits accounted for two-thirds of the dollar value of all claims.

Using the historical experience of the PBGC along with available information on the status of pension funding today, CBO has made

a preliminary projection of the revenue needs of the PBGC. This projection assumes that the accumulated deficit will be repaid over 15 years and that future claims will grow at the same rate as wages from a level of \$650 million in 1988. On this basis, the annual premium required to pay the PBGC's costs is estimated to be roughly \$30 per participant in 1988, assuming that the insurance premium is indexed in future years to grow with average wages. Because of the large degree of uncertainty in predicting future insurance claims against the PBGC, however, reasonable estimates of its future revenue needs can vary widely.

Even if the PBGC's financial problems necessitate program changes, corrective measures may not be immediately essential. A high proportion of the agency's liabilities actually represent benefits that will not be paid for several years, so that the program does not have immediate unmet cash needs. While CBO estimates that the PBGC will have to transfer assets from its trust fund to its revolving fund to meet benefit payments beginning in 1989, the PBGC could probably make benefit payments on a pay-as-you-go basis for more than a decade.

On the other hand, delay in taking corrective actions is likely to lead to continued growth in the accumulated deficit. Recent financial difficulties may be symptomatic of problems in the design of the insurance program—such as its lack of incentives for sponsors to fund their plans fully. Moreover, the funding rules for pensions in general may be inadequate to ensure that plans will be sufficiently funded. If future claims against the PBGC continue to grow, the result could be higher premiums for future participants in pension plans, thus shifting program costs from current participants and limiting the future attractiveness of defined-benefit pensions. Furthermore, significant delays in taking corrective steps could lead to the use of federal general revenues to help fund an even higher accumulated deficit—thus placing some of the financial burden on future taxpayers.

If desired, a variety of specific options for change are available. Some would reallocate costs among sponsors of plans. Others would alter existing rules about the funding of pensions and the termination of underfunded plans. Most of these options would indirectly improve the financial status of the PBGC, in some cases substantially. Alternatively, or in addition, changes could be made to raise revenues or reduce outlays directly.

One concern is that the annual premium paid on behalf of participants in plans is the same regardless of the insurance risk posed by their plans. In response, the PBGC has proposed combining a variable-rate premium based on the amount by which the plan was underfunded with an increase in the average premium charged to all covered plans.

CBO is now analyzing this proposal using 1984 data about the financial status of pensions. According to our preliminary results, if the PBGC's proposal had been in effect in 1984, the minimum premium of \$8.50 would have been paid on behalf of about three-quarters of covered participants. Higher premiums would have been paid on behalf of roughly 12 percent of participants in plans that were less than 100-percent funded in that year, plus another 12 percent of participants in plans that were between 100- and 125-

percent funded. About 3 percent of participants were in plans that would have been assigned the maximum premium of \$100.

Revenue derived from this proposal in future years would depend on the overall level of funding of pension plans, the distribution of funding among plans, and their sizes. Very preliminary projections by CBO indicate that in 1987 the PBGC's proposal would generate about \$700 million in revenue, or about \$22 per participant. About 60 percent of these revenues would come from plans that are less than 100-percent funded.

As with many premium structures that might be explored, the incentives for increased pension funding contained in this proposal would not be likely to cause large changes in the behavior of the sponsors. Indeed, under the PBGC's proposal of charging \$6 per \$1,000 of underfunding per participant, it would be considerably cheaper for the sponsor to pay the \$6 for several years than to make up the \$1,000 funding shortfall.

Given the tremendous uncertainties in the magnitude of future insurance claims and in the funding levels of pensions, the PBGC's proposal also offers one mechanism for adjusting the premium in the future. CBO has not, however, had sufficient time to analyze the likely success of this option.

A second concern about pensions is that, by its very nature, insurance of private pension benefits increases the likelihood that pensions will be underfunded and that underfunded plans will be terminated. One approach to limit these effects would be to reduce from 30 years the allowed amortization periods for certain supplemental pension liabilities. Alternatively, or in addition, minimum funding standards could be strengthened.

Finally, if direct changes in the financial status of the PBGC are deemed appropriate, several options are available. Each \$1 increase in the PBGC premium in 1988, for example, would generate about \$30 million in revenue. Alternatively, the priority of PBGC's claim in bankruptcy proceedings on the assets of sponsors of terminated underfunded plans could be raised, or Federal general revenues could be used to pay part of the PBGC's accumulated deficits, or benefits for new claimants could be reduced. Lowering protection for new claims to 85 percent of the present guarantee could reduce insured claims against the PBGC by about \$100 million in 1988. Alternatively, the maximum benefit guaranteed by the program could be cut from the current \$1,858, or insurance coverage for particular types of benefits could be ended.

Supporters of these limitations maintain that it is fair to require workers who will benefit from the program's protection to share directly in the costs of restoring its financial stability. Opponents contend, however, that reductions in benefits are contrary to the Government's promise to protect earned pension benefits, and that current guarantees are not excessive.

In conclusion, many options are available to respond to the growing financial problems of the PBGC. In particular, the administration is proposing a variable-rate premium to cover the costs of pension insurance. Earlier it suggested ways to strengthen the minimum funding standards for defined-benefit plans. While it is not essential that the Congress act quickly, delaying could lead to larger accumulated deficits and harder policy choices in the future.

Thank you, Mr. Chairman. We would be pleased to answer any questions.

[The prepared statement follows:]

Statement of
Nancy M. Gordon
Assistant Director
Human Resources and Community Development Division
Congressional Budget Office

In 1974, as part of a broader effort to protect participants in private pension plans, the Congress created a federal program of pension insurance to be operated by the Pension Benefit Guaranty Corporation (PBGC). The purpose of this agency is to ensure that workers receive certain retirement benefits promised by their employer, if their pension plan is terminated with insufficient assets to pay for these benefits.

Almost from the start, the pension insurance program for single-employer plans has had financial difficulties, and the PBGC itself has accumulated a large and growing deficit. Last year, the Congress responded to these and related issues by making changes in pension policies generally and by modifying the pension insurance program in particular. With the near tripling of the program's accumulated deficit during 1986 to \$3.8 billion, however, concern has been expressed that additional changes are needed to assure the financial viability of the program.

My remarks today will focus on three topics:

- o Information on the operation and financial status of the federal pension insurance program;
- o Issues raised by the rapid growth in the accumulated deficit of the PBGC; and

- o A range of specific options to address the PBGC's problems, most of which would improve its financial situation.

FEDERAL INSURANCE OF PRIVATE PENSION BENEFITS

Employers need not provide pensions for their workers, but if they do, the federal government requires them to follow rules relating to most major aspects of the plan's operation. In particular, an employer who sponsors a so-called defined-benefit pension plan—one that promises a specified annual pension benefit in retirement rather than simply providing contributions to workers' retirement accounts—is required to contribute at least a minimum annual amount to that plan as benefit commitments accrue. Annual payments must be sufficient to cover the normal cost of benefits accrued by workers in that year, as well as a portion of any other so-called supplemental pension liability that usually can be amortized over periods of 15 years or 30 years.

Even if they satisfy all legal funding obligations, pension plans can be underfunded if they terminate, largely because of the time involved in paying for amortized supplemental pension costs. These supplemental costs include benefit obligations, such as those resulting from granting pension benefits for service before the plan began and from amending the plan to increase or extend benefits. Supplemental costs can also arise from

unexpected changes in other factors, such as the early retirement of large numbers of workers or the poor investment performance of the plan's assets.

While the federal government does not restrict the termination of sufficiently funded pensions, those with funding shortfalls can only be terminated if the sponsor of the plan is in bankruptcy proceedings or generally would be unable to pay its debts without the termination. Once an underfunded plan is terminated, the PBGC takes over all of its assets, assumes liability for all guaranteed benefits, and attempts to recover any remaining liability of the sponsor. ^{1/} Since 1975, of the over 70,000 single-employer pensions that have terminated, about 1,350--or less than 2 percent--contained some unfunded benefits that were then taken over by the PBGC. Funds to pay for this insurance protection are derived from an annual premium of \$8.50 for each pension participant, plus resources from terminated underfunded plans and their sponsors.

Because guaranteed benefits are limited in a number of ways, benefits paid by the PBGC to participants in terminated underfunded plans can be less than the amount they would have received had their plan not terminated. Only benefits vested before the plan is terminated are

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1. Sponsors of terminated underfunded plans are liable to the PBGC for up to 30 percent of their net worth for unfunded guaranteed benefits, plus 75 percent of the difference, if any, between the unfunded guaranteed benefits and 30 percent of net worth.

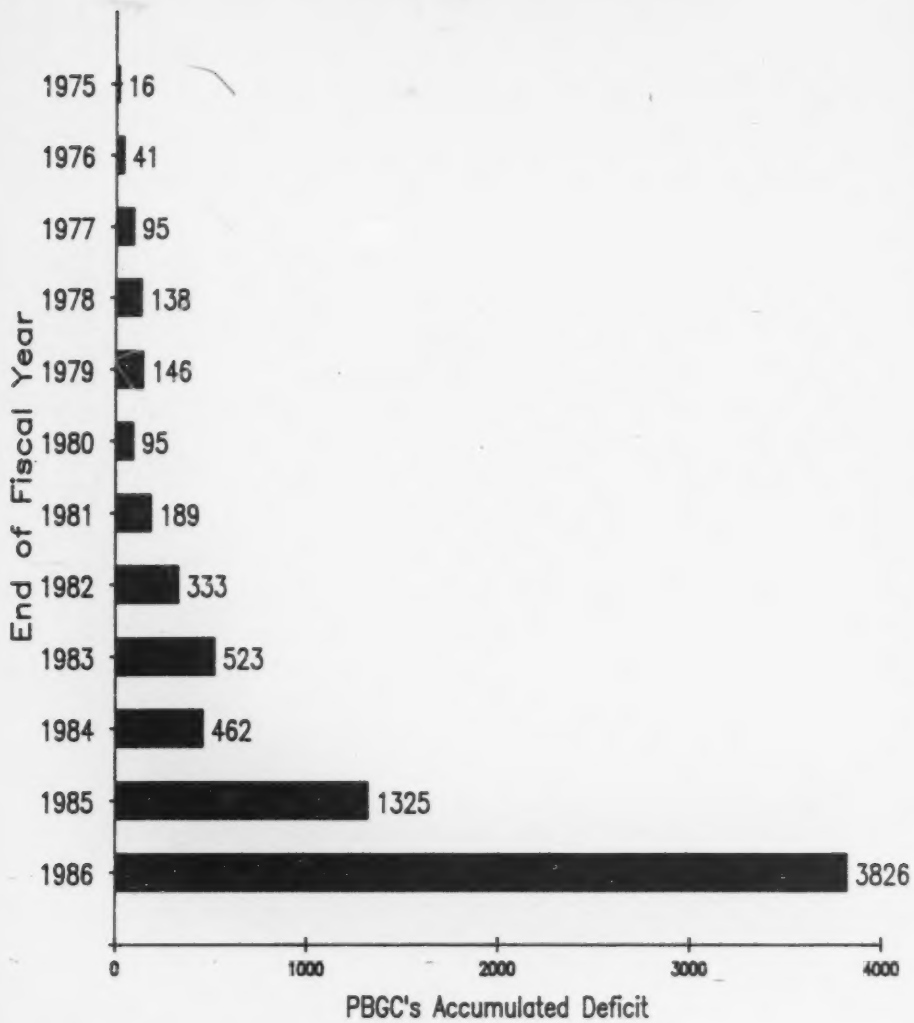
guaranteed by the PBGC, for example, and those benefits are not fully guaranteed unless they have been a part of the pension agreement for at least five years. Maximum guaranteed monthly benefits are limited to an indexed amount that is currently \$1,858 for a life annuity beginning at the normal retirement age. In addition, the guarantee applies to the nominal dollar benefit of the plan. Benefits are not protected against inflation that occurs either before or after a worker retires.

The Financial Status of the PBGC

At the end of 1986, the PBGC had an accumulated deficit of \$3.8 billion. ^{2/} This shortfall is the difference between the present value of liabilities for benefit payments of about \$7.4 billion and assets of about \$3.6 billion. The present value of liabilities represents the amount of money that would be needed today to purchase annuities sufficient to pay when due all current and future benefits for which the PBGC has already accepted responsibility. As displayed in Figure 1, this accumulated deficit has increased during all but two years since the program began. Ignoring potential future claims, the Congressional Budget Office (CBO) estimates that the accumulated deficit could be repaid with a one-time charge of about \$120 per insured participant.

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2. The term "accumulated deficit" refers to the unfunded portion of the PBGC's liabilities that have been generated since the program began in 1974, and not to the annual change in this unfunded liability.

Figure 1. Accumulated Deficit of the PBGC,
1975-1986 (In millions of dollars)



Source: CBO based on PBGC's Annual Report, various years.

A large part of the dollar value of claims against the PBGC has been made by an exceedingly small number of plans (see Table 1). For example, of the 1,350 underfunded pension plans terminating since 1975, the eight plans with the largest levels of unfunded benefits accounted for two-thirds of the dollar value of all claims. Fully 87 percent of claims for unfunded benefits were made by 3 percent of all terminating underfunded plans with the largest unfunded liabilities. Moreover, terminated pensions in the steel industry alone amount to about 80 percent of all claims.

TABLE 1. DISTRIBUTION OF NET CLAIMS AGAINST THE PBGC, 1975-1986

Category of Claim (In millions of dollars)	Number of Plans Making Claims	Net Claims in Category (In millions of dollars)	Net Claims in Category as Percentage of Total Net Claims
Greater than 100	8	2,636	68
50-100	1	55	1
25-50	12	416	11
10-25	19	295	8
5-10	22	159	4
1-5	107	228	6
Less than 1	<u>1,176</u>	<u>111</u>	<u>3</u>
Total	1,345	3,900	100

SOURCE: CBO calculations based on PBGC Annual Report, 1986.

NOTES: Data are in current dollars and reflect the amount of the claim on the date the pension plan was terminated. Details may not add to totals because of rounding.

Future Prospects

The future financial condition of the pension insurance program is highly uncertain because it will depend largely on how many private pension plans terminate and on the amount of underfunding in those plans. Both factors are hard to forecast accurately. Moreover, a few pension plans with extremely large unfunded liabilities have dominated PBGC's past claims, and its future may likewise depend significantly on the fate of a small number of large plans--making liabilities even more difficult to predict. The number of terminations is influenced by overall economic conditions, by the prosperity of particular industries, by competition from abroad, and by a variety of factors that are specific to a particular firm--such as its competitive position in the industry, its agreements with labor groups, and the assessment of its financial prospects that are necessary for it to obtain credit.

Using the historical experience of the PBGC along with available information on the status of pension funding today, CBO has made a preliminary projection of the revenue needs of the PBGC. This projection assumes that the accumulated deficit will be repaid over 15 years and that future claims will grow at the same rate as wages from a level of \$650 million in 1988. On this basis, the annual premium required to pay the PBGC's costs is estimated to be roughly \$30 per participant in 1988,

assuming that the insurance premium is indexed in future years to grow with average wages. Because of the large degree of uncertainty in predicting future insurance claims against the PBGC, however, reasonable estimates of its future revenue needs can vary widely.

Even if the PBGC's financial problems necessitate program changes, corrective measures may not be immediately essential. A high proportion of the agency's liabilities actually represent benefits that will not be paid for several years, so that the program does not have immediate unmet cash needs. While CBO estimates that the PBGC will have to transfer assets from its trust fund to its revolving fund to meet benefit payments beginning in 1989, the program is not expected to deplete its assets for several years. Indeed, given its current assets, future premium receipts, and assets derived from the future terminations of partially funded pensions, the PBGC could probably make benefit payments on a pay-as-you-go basis for more than a decade.

On the other hand, delay in taking corrective actions is likely to lead to continued growth in the accumulated deficit. Recent financial difficulties may be symptomatic of problems in the design of the insurance program—such as its lack of incentives for sponsors to fund their plans fully.

Moreover, the funding rules for pensions in general may be inadequate to ensure that plans will be sufficiently funded. If future claims against the PBGC continue to grow, the result could be higher premiums for future participants in pension plans, thus shifting program costs from current participants and limiting the future attractiveness of defined-benefit pensions. Furthermore, significant delays in taking corrective steps could lead to the use of federal general revenues to help fund an even higher accumulated deficit--thus placing some of the financial burden on future taxpayers.

CURRENT ISSUES

The accelerated decline in PBGC's financial position has focused concern on several issues, including the types of benefits that should be insured by the PBGC and who should pay for the insurance protection.

What Types of Benefits Should be Insured?

Some analysts have proposed reconsidering the nature of the insurance protection provided by the PBGC. In particular, the issue is whether or not the government should continue to insure pension benefits that have not been fully funded at least at some time in the past, usually because certain pension costs were amortized over several years.

The basic argument for denying insurance protection for underfunded benefits is that insuring them goes well beyond the traditional protection provided by government in other areas, such as in insuring bank deposits. In the case of the PBGC, insurance is provided both against market-related fluctuations in the portfolios of pension plans and against the inability of sponsors to provide sufficient future funding to meet their past pension promises. Yet the government's own rules are often the source of underfunding. Current federal rules and accepted actuarial principles allow sponsors to spread their pension costs over many years, thereby raising the likelihood that the PBGC will be called on to pay for some of these benefits.

Who Should Pay for Insurance Protection?

With recent growth in the cost of pension insurance—from \$1 per participant in the original legislation in 1974, to \$2.60 in 1978, and to \$8.50 today—and with the prospect of considerably higher insurance premiums in the future, the issue of who should pay them becomes an increasingly important one.

Several alternative allocations of the costs of pension insurance are possible. One would be to continue distributing the costs equally among participants in all defined-benefit pension plans. This approach spreads program costs widely. But it includes—in large part—pensions that have little likelihood of making a claim. In addition, because the insurance costs

remain the same regardless of the plan's funding position, it provides no incentive for participants or sponsors to increase the funding levels in their plans.

Alternatively, insurance costs could be targeted on plans that are more likely to make claims against the PBGC. This allocation would tie premium payments more closely to anticipated costs, and would also provide an incentive for participants and sponsors to raise the funding levels in their plans. Better funding, in turn, would both reduce the probability of insurance claims and lower their insurance premiums. But charging higher premiums to less well-funded plans could itself worsen their financial condition, thereby potentially making it more likely that those plans would be terminated and that claims would be made against the PBGC.

Finally, costs could be distributed more broadly among all taxpayers by using federal general revenues to support PBGC's shortfalls. This method would insulate plans that continue in operation from any financial difficulties caused by terminated ones. It could be viewed as an inappropriate use of federal funds, however, because taxpayers in general would be supporting a relatively small number of participants, many of whom have above-average wages.

SPECIFIC ALTERNATIVES

A variety of options are available that would address the issues just discussed. Some would reallocate costs among sponsors of plans. Others would alter existing rules about the funding of pensions and the termination of underfunded plans. Most of these options would indirectly improve the financial status of the PBGC, in some cases substantially. Alternatively, or in addition, changes could be made to raise revenues or reduce outlays directly.

Options for Altering the Allocation of Program Costs

One concern is that the annual premium paid on behalf of participants in plans is the same regardless of the insurance risk posed by their plans. Instead, a so-called variable-rate premium structure could be used, in which the premium charged on behalf of pension participants would vary among plans according to some measure of the risk that each plan represents to the PBGC.

Designing a Variable-Rate Premium Structure. If a variable-rate premium structure were adopted, it would have to include a basis for assessing premiums, and might also specify maximum or minimum premiums to be charged. The assessment of the premium could be based on the level of unfunded benefits in the plan that are guaranteed by the PBGC (called the "exposure" of the PBGC for that plan), on the risk that the plan will terminate with a claim against the PBGC, or on both.

Any premium based on exposure or risk might also include maximum and/or minimum values for the annual charge. An upper limit, or cap, on the annual premium per participant would lessen the chances that the cost of the insurance itself would lead to financial difficulties for the sponsor or to termination of the plan. At the same time, however, it would limit the extent to which the insurance costs were allocated according to exposure or risk. A minimum premium that is greater than zero would allow certain program costs to be shared by participants in all covered plans, but would also somewhat lessen the incentive for sponsors to fund their plans fully.

The PBGC's Proposal. The PBGC's proposal would combine a variable-rate premium based on the amount by which the plan was underfunded with an increase in the average premium charged to all covered plans. This proposal would set the minimum annual charge at \$8.50 per participant and the maximum charge at \$100 per participant. It would raise the annual premium above the \$8.50 base by \$6 for each \$1,000 per participant that the plan is underfunded. This underfunding is determined by the difference between plan assets and 125 percent of liabilities, which are calculated as if the plan is being terminated.

CBO is now analyzing this proposal using 1984 data about the financial status of pensions. According to our preliminary results, if the PBGC's proposal had been in effect in 1984, the minimum premium of \$8.50 would have been paid on behalf of about three-quarters of covered participants.

Higher premiums would have been paid on behalf of roughly 12 percent of participants in plans that were less than 100 percent funded in that year, plus another 12 percent of participants in plans that were between 100 percent and 125 percent funded. About 3 percent of participants were in plans that would have been assigned the maximum premium of \$100.

Revenue derived from this proposal in future years would depend on the overall level of funding of pension plans, the distribution of funding among plans, and their sizes. Very preliminary projections by CBO indicate that in 1987 the PBGC's proposal would generate about \$700 million in revenue, or about \$22 per participant.

As with many premium structures that might be explored, the incentives for increased pension funding contained in this proposal would not be likely to cause large changes in the behavior of the sponsors. Indeed, under the PBGC's proposal of charging \$6 per \$1,000 of underfunding per participant, it would be considerably cheaper for the sponsor to pay the \$6 for several years than to make up the \$1,000 funding shortfall. The proposal could speed up the funding of some underfunded plans, however, if the sponsors of those plans already intended to reduce their underfunding in the near future. Moreover, these incentives could be strengthened somewhat by charging rates that would increase according to the extent of plan underfunding.

Given the tremendous uncertainties in the magnitude of future insurance claims and in the funding levels of pensions, the PBGC's proposal also offers one mechanism for adjusting the premium in the future. CBO has not, however, had sufficient time to analyze the likely success of this option.

Options for Reducing Underfunding or
the Termination of Underfunded Plans

By its very nature, insurance of private pension benefits increases the likelihood that pensions will be underfunded and that underfunded plans will be terminated. To limit these effects, some analysts have proposed changes in the methods currently used to fund pensions and in the treatment afforded certain benefits.

Increase Minimum Annual Pension Contributions by Plans Sponsors.

Increasing annual pension contributions by plan sponsors would be one way to increase pension funding throughout the lives of the plans. One approach would be to reduce from 30 years the allowed amortization periods for certain supplemental pension liabilities. Alternatively, or in addition, minimum funding standards could be strengthened. The Administration has proposed, for example, requiring annual pension contributions to depend on the extent to which a plan is underfunded, or just barely funded.

To avoid the severe disruptions that would occur for some firms, both approaches could be implemented gradually. In that case, however, reductions in underfunding would occur more slowly, leaving the PBGC exposed to larger claims in the interim.

More rapid funding of pension obligations could increase the likelihood that the assets of pension plans would be available to pay promised benefits, while the added pension contributions generally would not come at a time when the sponsors were in severe financial difficulty. On the other hand, requiring higher pension contributions might lead to slower wage growth for the sponsors' employees and discourage the use of defined-benefit plans.

Alter the Treatment of Benefits Derived from Layoffs or Plant Closings. Altering the treatment of extra pension benefits derived solely from layoffs or plant closings could limit the extent to which these benefits result in claims against the PBGC. Although sizable portions of these benefits are not insured, they can lead to higher claims either because a portion of them are insured or because they are paid to participants--in lump sums, for example--before the plan is terminated, thereby reducing the funds that remain to pay guaranteed benefits later. The PBGC estimates that, in the steel industry, roughly \$1 billion in unfunded claims have resulted from these benefits, although there is little other data on the inclusion of these benefits in pension agreements. Instead, the payment of

these benefits could be made conditional on funds being available, perhaps in a separate account that could not be used to meet minimum funding standards.

Supporters of this change maintain that it could lead to less reliance on this type of pension benefit, and reduce claims against the PBGC. On the other hand, opponents contend that these benefits are often necessary to protect the income security of workers who lose their jobs. Moreover, the benefits may make affected workers more willing to accept overall economic change--thereby potentially improving the adaptability of the economy, which would ultimately benefit everyone.

Options for Directly Raising Revenues or Reducing Outlays

If direct changes in the financial status of the PBGC are deemed appropriate, several options are available, including raising the insurance premium charged on behalf of covered participants, increasing receipts from other sources, and reducing outlays for benefits.

Increase the Premium Charged on Behalf of Pension Participants.

Revenues could be raised directly by increasing the insurance premium charged on behalf of participants in covered pensions. Each \$1 increase in the PBGC premium in 1988, for example, would generate about \$30 million in revenue. Raising the premium could be accomplished with a one-time

increase, or by indexing the premium to changes in an indicator, such as the level of claims against the PBGC or average wages in the economy. Such an increase could be made either with or without also changing to a variable-rate structure, as proposed by the PBGC.

Raising revenues by increasing the PBGC premium would help to restore solvency to the program by using the mechanism originally designed to provide such stability. On the other hand, large increases in pension premiums could discourage the future use of defined-benefit pensions, with a possible reduction in the income security of affected workers.

Increase Other Receipts. Revenues could also be increased in other ways, including raising the priority of PBGC's claim in bankruptcy proceedings on the assets of sponsors of terminated underfunded plans, or by using federal general revenues to pay part of the PBGC's accumulated deficit.

Raising PBGC's priority in bankruptcy proceedings would increase recoveries from some terminated underfunded pension plans, but these added funds would come at the expense of those sponsors' other creditors. Moreover, sponsors with underfunded pensions might be less able to obtain credit under these rules, potentially raising the likelihood that they would become insolvent and their plans would be terminated.

Obtaining funds from federal general revenues would satisfy the need for increased revenues without discouraging the continued use of defined-benefit pensions. On the other hand, using federal funds in this way could be viewed as inappropriate, because they would support voluntary private pension plans that benefit only a portion of the population.

Reduce Outlays for Benefits. Reducing benefits for new claimants would also directly improve the financial situation of the PBGC. Expenditures could be reduced by lowering benefit protection across the board--such as by limiting PBGC's insurance payments to some fraction of their previous level--or by lowering the maximum benefit guaranteed by the program, or by reducing insurance coverage for particular types of benefits. Reducing benefit protection for new claims to 85 percent of the present guarantee could reduce insured claims against the PBGC by about \$100 million in 1988. Limiting insurance protection for unfunded benefits that result from past service credits or plan liberalizations could also have a noticeable impact on PBGC's future claims, whereas reducing the maximum benefit guarantee from the current \$1,858 per month would have a much smaller one, because relatively few claimants reach that cap.

Supporters of these limitations maintain that it is fair to require workers who will benefit from the program's protection to share directly in

the costs of restoring its financial stability. Opponents contend, however, that reductions in benefits are contrary to the government's promise to protect earned pension benefits, that current guarantees are not excessive, and that there is no justification for treating future claimants differently from those whose underfunded plans have already terminated.

CONCLUSION

Many options are available to respond to the growing financial problems of the PBGC. In particular, the Administration is proposing a variable-rate premium to cover the costs of pension insurance. Earlier it suggested ways to strengthen the minimum funding standards for defined-benefit plans. While it is not essential that the Congress act quickly, delaying could lead to larger accumulated deficits and harder policy choices in the future.

Chairman PICKLE. Thank you, Mrs. Gordon.
I will be pleased to hear from Mr. Delfico.

STATEMENT OF JOSEPH F. DELFICO, SENIOR ASSOCIATE DIRECTOR, HUMAN RESOURCES DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY CHRISTOPHER DOYLE, PENSION ACTUARY; AND LARRY WOOD, PAUL REYNOLDS, AND FRANK KOVALAK, PENSION GROUP

Mr. DELFICO. Thank you, Mr. Chairman. With your permission, I would like to submit the full testimony for the record and summarize my remarks.

Chairman PICKLE. Without objection.

Mr. DELFICO. With me today is our pension actuary, Mr. Christopher Doyle, and Mr. Larry Wood, Mr. Paul Reynolds and Mr. Frank Kovalak of our pension group will be available for questions.

I am pleased to be here today to discuss the financial condition of the single employer pension insurance program and changes that the Congress may wish to consider to improve it. These are two subjects covered in a recent report we prepared for this subcommittee.

The single employer insurance program is in serious financial trouble. As of September 30, 1986, the program's reported deficit was \$3.8 billion, as you have heard this morning. Moreover, program benefit payments are expected to cause an asset drain that could render the program insolvent within 15 years.

The deficit has grown dramatically in recent years due primarily to large claims from the termination of underfunded plans of a relatively few employers. The deficit grew from \$330 million to \$1.3 billion during fiscal years 1983 through 1985, and then almost tripled to \$3.8 billion in fiscal year 1986.

Despite positive effects, the Single Employer Pension Plan Amendments Act of 1986 may not be enough to ensure the program's long-term financial viability because the majority of the claims dollars have resulted from plans terminated by bankrupt employers, and a significant increase in the recovery of such claims is not likely because the corporation's claims in bankruptcy proceedings continue to have low priority.

Further, based on the corporation's recent estimates, the premium rate of \$8.50 is not projected to generate enough revenue to keep the program solvent.

In our work for you, we reviewed 33 plans to identify the major causes of their underfunding at termination. These plans caused the largest claims in 1983 through 1985. We found that about 70 percent of the claims resulted primarily because employers were not required under Federal funding standards to make sufficient contributions to pay for rising unfunded guaranteed benefits. These claims were in part due to numerous benefit increases within 5 years of termination.

The remaining 30 percent of the claims resulted from employers not having made required contributions before the plans were terminated.

To help control potential claims, we suggested strengthening the funding standards and lowering benefit guarantees. To better fi-

nance claims, we suggested Congress consider raising the programs premium rate and the priority of its claims in bankruptcy proceedings. The administration proposes to strengthen plan funding and increase premium revenue using a variable rate approach. Although we have not had sufficient time to make a detailed analysis of these proposals, I would like to make some preliminary observations of their major provisions. We endorse the intent of the administration's proposals to reduce the single employer insurance program's claims exposure by tightening the funding standards and better finance program costs through a variable premium. Both proposals should be considered as a package rather than on an individual basis because their cost implications are targeted toward the same general population—poorly funded plans.

We estimate based on the latest available data that about 25 percent of the plans with a hundred or more participants will be affected. Because a number of plans will be affected, the proposal should include adequate transition rules so that the burden of the new costs resulting from the proposals are phased in over a period of time.

The corporation proposes a variable premium with automatic adjustment features. Specifically, the proposal presents a basic premium that includes a flat rate of \$8.50 per participant for all plans, plus an additional charge of \$6 per \$1,000 of underfunding to be paid by plans with a hundred or more participants.

Underfunding will be determined by subtracting assets from 125 percent of estimated termination liability. Although the premium is initially capped at \$100 per participant, other charges could raise the cap for plans not paying contributions computed under the funding standards.

Both the \$8.50 rate and the \$100 cap are to be indexed annually to the Social Security wage base. In addition, the \$6 underfunding charge can be adjusted, but by no more than 50 percent automatically every 3 years, based on the program's claims experience.

We support the variable premium because it provides a more equitable approach to distributing program costs than the current flat rate. Including an automatic adjustment mechanism is a critical element, given the uncertainty in the program's revenue needs and the potential revenue that will be generated by the variable rate structure.

It is virtually impossible to predict future claims which greatly affect revenue requirements, and better data is needed on the extent of plan underfunding. However, certain aspects of the proposal warrant further consideration. We believe that premium payers should finance program costs as close to when they are incurred as possible, and that the administration should not alter its previous goal of retiring the deficit in 15 years. Extending the retirement period to 30 years as proposed increases the transfer of responsibility for past program costs to future generations of premium payers. We find it inconsistent for the new proposals to require underfunded plans to amortize their liabilities over shorter periods on the one hand, and the corporation to extend their amortization period to 30 years on the other.

Such potential inequities could be reduced by increasing the base premium charge to all plans above the \$8.50 rate. We estimate that

the base premium of \$12.50 would be needed to retire the program's existing deficit over 15 years.

The administration's funding standards proposal includes several changes to help reduce potential claims. The major thrust of the proposal is to require more rapid amortization of a plan's unfunded termination liabilities. Other changes would require all plans to pay contributions quarterly rather than 8½ months after plan year end; and reduce the number of funding waiver now allowed, while requiring quicker payment of those that are granted. These changes address the causes of underfunding identified in our recent report.

We believe these changes should meet the same criteria set out by the corporation for the variable premium—simplicity, equity and avoidance of unreasonable burden. Though information made available to us by the administration on the proposals has been primarily conceptual and not specific enough, it appears that the changes could be financially burdensome to some plans that are significantly underfunded and to others, if there are abrupt changes in financial markets, because they could be required to pay substantially higher contributions than now required.

While some underfunded plans are sponsored by healthy employers, many are financed by employers who are experiencing financial difficulties. Imposing costs that are too high could force the termination of plans, reduce the granting of benefit increases designed to provide reasonable retirement income, and discourage the employers from establishing new defined benefit plans.

The administration's proposal, like prior reforms, are designed to resolve the program's financial crises by raising the cost of employers sponsoring insured plans. As an effort to limit the financial burden on employers, we believe that further consideration should be given to reducing premium costs by lowering the benefits granted.

For example, eliminating insurance program coverage of benefit increases within 5 years of the plan termination would reduce claims dollars. While we support the program's primary intent to protect participants' benefits, we believe that the establishment of affordable benefit guarantees may be an essential policy alternative to ensure the program's financial viability.

This concludes my prepared remarks. I will be happy to answer any questions you may have.

[The prepared statement and report follow:]

Statement of
Joseph F. Delfico, Senior Associate Director
Human Resources Division

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the financial condition of the single employer pension insurance program and changes that the Congress may wish to consider to improve it--two subjects covered in a recent report we prepared for this Subcommittee.¹

The insurance program, which is administered by the Pension Benefit Guaranty Corporation, generally guarantees workers' vested benefits when a plan terminates. Guaranteed benefits that exceed plan assets become program claims which are to be financed by collections from the plans' sponsoring employers. To the extent not collectible, claims are to be financed from premiums paid annually by ongoing plans. The program covers over 110,000 plans with over 30 million participants.

PROGRAM'S FINANCIAL CONDITION

The single employer insurance program is in serious financial trouble. As of September 30, 1986, the program's reported deficit was \$3.8 billion,² and the Corporation estimates that it could reach about \$8 billion by 1990. Moreover, annual program benefit payments, about \$260 million in fiscal year 1986, are expected to be \$650 million in 2 years, causing an asset drain that could render the program insolvent within 15 years.

The deficit has grown dramatically in recent years due primarily to large claims from the termination of underfunded plans of a relatively few employers. The deficit grew from \$333 million to \$1.3 billion during fiscal years 1983-85. It almost tripled to \$3.8 billion in fiscal year 1986 primarily because plans of the bankrupt LTV Corporation were terminated with unfunded benefits of about \$2 billion.

We reviewed 33 plans that accounted for 90 percent of the claims dollars incurred during fiscal years 1983-85 to identify the major causes of their underfunding at termination. We found that about 70 percent of the plans' claims resulted primarily because federal funding standards did not require sufficient contributions to pay for rising unfunded guaranteed benefits, in part due to numerous benefit increases in the years just before termination--27 of the 33 plans increased benefits during the 5 years before termination.

The remaining 30 percent of the claims resulted from employers not having made required contributions before the plans were terminated. Almost half represented contributions (generally covering all or part of a plan's last year of operations) that were not yet due because the payment deadline (8-1/2 months after the end of a plan year) came after plan termination. Also, significant percentages of the unpaid contributions either were overdue (32 percent) or had been waived (23 percent) by the Internal Revenue Service, the agency responsible for enforcing the funding standards.

POTENTIAL EFFECTS OF 1986 AMENDMENTS

The Single Employer Pension Plan Amendments Act, enacted in April 1986, should (1) prevent program claims from employers who

¹PENSION PLANS: Government Insurance Program Threatened by Its Growing Deficit (GAO/HRD-87-42, Mar. 19, 1987).

²We have not been able to express an opinion on whether the program's financial statements are presented fairly because of accounting and internal control weaknesses. Therefore, the program's deficit may be more or less than reported.

are not financially distressed by prohibiting them from terminating their underfunded plans, (2) increase claims recovery by raising employers' liability for unfunded benefits, and (3) increase program revenue by raising the annual premium from \$2.60 to \$8.50 per participant.

Despite these positive effects, the 1986 amendments may not be enough to ensure the program's long-term financial viability. The majority of the claims dollars have resulted from plans terminated by bankrupt employers. A significant increase in the recovery of such claims is not likely because the Corporation's claims in bankruptcy proceedings continue to have a low priority.

Further, the amendments' premium rate of \$8.50 is projected to generate \$273 million in revenue in fiscal year 1987. However, about \$424 million a year would be required if the program's current deficit of \$3.8 billion is to be retired over 15 years, the period used by the Corporation to determine the \$8.50 rate. The Corporation estimates that about \$650 million would be needed in fiscal year 1987 to finance other program costs, primarily new claims, and expects these costs to increase in future years.

Under these conditions, the premium revenue generated by the amendments will not be enough to retire the program's deficit, much less pay for unrecoverable claims from future plan terminations.

REFORM ALTERNATIVES

Our recent report presented additional reforms that the Congress might consider. To help control potential claims, we suggested strengthening the funding standards and lowering benefit guarantees. To better finance claims, we proposed raising the program's premium rate and the priority of its claims in bankruptcy proceedings.

The administration proposes to strengthen plan funding and increase premium revenue using a variable rate approach. Although we have not had sufficient time to make a detailed analysis of these proposals, I would like to make some preliminary observations on their major provisions. My comments are primarily based on (1) our experience over the last 5 years with the single employer pension plan insurance program, (2) discussions with Corporation officials, and (3) the administration's February proposal to change plan funding requirements.

PREMIUM REQUIREMENTS AND VARIABLE RATE STRUCTURE

According to the Corporation, the program's premium structure should generate adequate revenue to meet the program's financing needs and, in so doing, satisfy certain criteria. The premium structure should be simple to administer and enforce, equitable to plans, and avoid placing an unreasonable financial burden on plans and employers.

The Corporation proposes a variable premium with automatic adjustment features. Specifically, the proposal presents a basic premium that includes a flat \$8.50 participant charge for all plans plus an additional charge of \$6 for each \$1,000 of underfunding to be paid by plans with 100 or more participants. Underfunding will be determined by subtracting assets from 125 percent of estimated termination liability. Although the premium is initially capped at \$100 per participant, other charges could raise the cap to \$250 per participant for plans not paying contributions computed under the funding standards.

Both the \$8.50 rate and the \$100 cap are to be indexed annually to the Social Security wage base. In addition, the \$6 underfunding charge can be adjusted, but by no more than 50 percent, every 3 years based on the program's claims experience.

The Corporation estimates that the variable premium will generate enough revenue to eliminate the program's deficit over the next 30 years, pay for new claims (estimated at \$656 million in 1988), and cover administrative costs (\$40 million in 1988). However, the Corporation cautions that its claims estimate is very uncertain. Claims in recent years have been extremely volatile--ranging from \$40 million in 1984 to \$2 billion in 1986. Claims have come primarily from what the Corporation has called "catastrophic events"--the termination of a few employers' plans that were underfunded by large amounts. According to the Corporation, it is doubtful whether any methodology can be developed at this time to forecast the program's claims and, hence, revenue needs with precision. We agree.

Estimates of revenue under the current premium are relatively straightforward--total covered participants times \$8.50. A variable premium adds uncertainty because the Corporation's revenue estimates rely primarily on the extent of plans' underfunding, which could vary over time depending on such factors as changes in interest rates and employer contributions. Moreover, current or accurate data on underfunding are not maintained by the government. As a result, the Corporation cannot reliably estimate how much revenue the proposed premium will produce.

Because of these uncertainties, we agree with the Corporation's proposal to include automatic adjustment features in the premium. We took a similar position in 1983 and believe that the situation is much more critical today. An automatic adjusting premium should help the program react to its volatile claims experience by allowing more frequent changes in the premium rate to keep revenues more in line with costs. However, we have not had time to fully assess the impact of the proposal's premium adjustment features on the costs to plans and employers.

Although more complex than a flat \$8.50 rate per participant, the variable premium is simple to calculate using available plan data and information to be provided to plans by the Corporation. The proposed approach, which is based solely on a plan's potential claim against the program (exposure), is not as equitable as also considering a plan's probability of termination. Nonetheless, we believe it is more equitable than the existing flat rate because those plans generally representing no immediate potential claim would pay the lowest premium.

The new premium structure would increase premium costs for all plans whose assets are less than 125 percent of their termination liabilities, which includes some overfunded plans. Estimates of who will be affected and by how much vary with the data used to make the estimates. Using 1984 data on 12,832 plans with about 21 million participants, we estimate that, if the variable premium had been in effect that year, 74 percent of plans with 100 or more participants would not have paid any higher premium because they were more than 125 percent funded. About 1 percent of these large plans covering 3 percent of all participants would have paid a \$100 premium per participant and borne about 21 percent of the premium cost.

A determination of whether a variable premium would be burdensome to plans is a matter of judgment. To get an idea of its potential impact on a significantly underfunded plan, we calculated the 1984 premium for the plan causing the largest claim against the program as of September 1985. We found that the plan would have had to pay about \$860,000 under the variable premium rather than about \$73,000 at the \$8.50 rate. The

additional premium cost would have represented about 5 percent of the plan's required annual contributions and less than 1 percent of its ultimate claim against the program.

PLAN FUNDING STANDARDS

The existing funding standards were designed to provide reasonable assurance that an ongoing pension plan will systematically accumulate sufficient assets to pay benefits to participants as they become due. As I pointed out earlier, however, the standards do not assure that the benefits owed to participants will be funded if the plan terminates or that a plan's unfunded benefits will not grow over time.

The administration's funding standards proposal included several changes to help reduce potential claims. The major thrust of the proposal is to require more rapid amortization of a plan's unfunded termination liabilities. Other changes would (1) require all plans to pay contributions quarterly rather than 8-1/2 months after plan year end; and (2) reduce the number of funding waivers now allowed, while requiring quicker payment of those granted. These changes address the causes of underfunding identified in our recent report.

We believe these changes should meet the same criteria set out by the Corporation for the variable premium--simplicity, equity, and avoidance of unreasonable burden. However, information made available to us by the administration on the proposals has been primarily conceptual and not specific enough in certain key areas for us to make a detailed analysis.

In general, it appears that the proposed changes will have a limited effect on most plans because they appear sufficiently overfunded and will continue to follow the existing funding requirements. However, the changes will make already complex funding standards more complex for marginally overfunded and all underfunded plans. (Affected plans may have to compute contribution levels under three new funding requirements and compare the results to the contribution level required under the existing standard.) Further, it appears that the changes could be financially burdensome to those plans that are significantly underfunded because they could be required to pay substantially higher contributions than now required.

POLICY IMPLICATIONS

We endorse the intent of the administration's proposals to reduce the insurance program's claims exposure by tightening the funding standards and to better finance program costs through a variable premium. Furthermore, we believe that the proposals provide a useful framework for deliberating the major policy options available. Both proposals should be considered together, rather than individually, because their cost implications are targeted toward the same general population--poorly funded plans. In this regard, we believe that the Congress needs more information on the proposals and their effects to ensure that adequate safeguards, as transition rules, are put in place so that plans' total costs do not become unreasonably burdensome for employers.

As pointed out in our recent report, changes designed to improve the program's financial condition and otherwise protect the benefits owed to participants at plan termination can directly and indirectly affect employers, plan participants, the federal government, and other private companies. For example, raising the contribution requirements by changing the funding standards could affect participants because it may encourage some employers to hold down pension costs by reducing or eliminating future benefit increases or terminating their plan. Further, because contributions are tax deductible, government tax revenue

could (1) increase if plan terminations occur without an increase in other deductible expenses or (2) decrease if employers increase contributions without reducing other deductible expenses.

Funding Standards

The requirements for more rapid funding of a plan's unfunded liabilities and subsequent benefit increases represent the two most significant changes that can be made to the funding standards. Developing the specific triggers for determining contribution levels requires establishing a delicate balance between the need to reduce a plan's underfunding and the employer's ability to pay. While some underfunded plans are sponsored by healthy employers, many are financed by employers who are experiencing financial difficulties. Imposing too high costs could force the termination of plans, reduce the granting of benefit increases designed to provide a reasonable retirement income, and discourage other employers from establishing new defined benefit plans.

In order to minimize the burden of policy changes in such instances, it will probably be necessary to establish contribution requirements that, while higher than existing standards, may not represent the highest level needed to immediately protect the program from large claims. As a result, we believe that changes to the funding standards should be viewed as long-term solutions to the program's financial problems.

Premium Requirements

Because of the present large imbalance between program costs and revenues, changes are needed in the premium structure to slow the expected erosion of program assets over the next 15 years. We support the variable premium because it provides a more equitable approach to distributing program costs than the current flat rate. Including an automatic adjustment mechanism is a critical element given the uncertainty in the program's revenue needs and in the potential revenue that will be generated by the variable rate structure.

Certain aspects of the proposal warrant further consideration. We believe that premium payers should finance program costs as close to when they are incurred as possible and that the administration should not alter its previous goal of retiring the deficit in 15 years. Extending the retirement period to 30 years, as proposed, increases the inequitable transfer of responsibility for past program costs to future premium payers. Such potential inequities could be reduced by increasing the base premium charged to all plans above the current \$8.50 rate. A base premium of \$12.50 would be needed to retire the program's existing deficit over 15 years.

Benefit Guarantees

The administration's proposals, like prior reforms, are designed to resolve the program's financial crisis by raising the costs of employers sponsoring insured plans. As an effort to limit the financial burden on employers, we believe that further consideration should be given to reducing program costs by lowering the benefits guaranteed. For example, eliminating insurance program coverage of benefit increases within 5 years of plan termination would reduce claims dollars. While we support the program's primary intent to protect participants' benefits, we believe that the establishment of affordable benefit guarantees may be an essential policy alternative to ensure the program's financial viability.

This concludes my prepared remarks. I will be happy to answer any questions you may have.

GAO

United States General Accounting Office

**Report to the Chairman, Subcommittee on
Oversight, Committee on Ways and
Means, House of Representatives**

March 1987

PENSION PLANS

Government Insurance Program Threatened by Its Growing Deficit



GAO/HRD-87-42



United States
General Accounting Office
Washington, D.C. 20548

Human Resources Division

B-222943

March 19, 1987

The Honorable J. J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

This report responds to your February 12, 1986, request for information on the causes of large claims against the Pension Benefit Guaranty Corporation's single-employer pension plan insurance program and the potential effects of the Single Employer Pension Plan Amendments Act of 1986 on the program. The report discusses several suggested changes that the Congress should consider to enhance the program's long-term financial viability.

As requested by your office, we will not make additional distribution of this report for 24 hours. At that time, we will send copies to the Pension Benefit Guaranty Corporation, the Internal Revenue Service, various congressional committees and subcommittees concerned with pension issues, and other interested parties.

Sincerely yours,

A handwritten signature in cursive script that reads "Richard L. Fogel".

Richard L. Fogel
Assistant Comptroller General

Executive Summary

Purpose

The Employee Retirement Income Security Act of 1974 (ERISA) established funding standards and an insurance program to protect the benefits of about 30 million participants in over 110,000 single employer defined benefit pension plans. As of September 30, 1985, the insurance program reported a deficit of \$1.3 billion. The deficit was estimated to be about \$4 billion in January 1987 primarily because plans of the bankrupt LTV Corporation were terminated with unfunded benefits of about \$2 billion.

The Single Employer Pension Plan Amendments Act, enacted in April 1986, included provisions to improve the program's financial condition. This report, requested by the Chairman, Subcommittee on Oversight, House Committee on Ways and Means, assesses the causes of large claims against the program and the potential effects of the 1986 amendments on the program.

Background

The funding standards require employers to contribute a minimum amount of money annually for their plans' estimated current year cost and amounts needed to pay off unfunded liabilities, such as those arising from benefit increases for participants' past service, which can be paid over specified periods—generally up to 30 years. The contributions are due not later than 8-1/2 months after the end of the plan year they cover unless waived by the Internal Revenue Service (IRS), which enforces the standards. Unpaid contributions, however, generally come due upon plan termination. (See pp. 13 and 14.)

The insurance program, administered by the Pension Benefit Guaranty Corporation (PBGC), generally guarantees the benefits of participants in terminated plans. Benefits not covered by plan assets represent an insurance claim that is to be financed by (1) collections from employers causing the claims and (2) premiums paid by ongoing insured plans. (See pp. 8 and 9.)

The amendments were designed to (1) prevent claims from plans terminated by employers that are not financially distressed, (2) increase claims recovery from financially distressed employers by raising their liability for unfunded benefits, and (3) raise program revenue by increasing the premium rate. (See pp. 20 and 21.)

Results in Brief

GAO found that \$451 million (90 percent) of the program's \$501 million in claims during 1983-85 was caused by 23 employers terminating 33 plans. Of these claims,

- 70 percent resulted from the funding standards not requiring sufficient contributions to pay for the plans' rising unfunded guaranteed benefits, in part due to numerous benefit increases within 5 years of termination, and
- 30 percent resulted from required contributions not being paid before the plans were terminated. (See pp. 9, 12, and 13.)

Despite their positive effects, the 1986 amendments may not be enough to ensure the program's long-term financial viability. If the amendments had been in place when the 23 employers terminated their plans, they could have prevented claims from a few of the employers who were not financially distressed and better financed the claims that did occur. However, the majority of the claims dollars came from plans terminated by financially distressed employers. (See ch. 3.)

The 1986 amendments would not likely have resulted in a significant increase in PBGC's recovery of such claims because the employers were in bankruptcy proceedings and PBGC's claims in such proceedings continue to have a low priority. Considering current and expected future conditions, the premium revenue generated under the amendments will not be enough to retire the program's current deficit, much less pay for unrecoverable claims from future plan terminations. More importantly, PBGC officials now expect the program to become insolvent within 15 years. (See ch. 3.)

Principal Findings

Contributions Not Sufficient to Fund Increased Benefits

The unfunded benefits of the 33 terminated plans almost doubled during the 5 years before termination—growing from \$232 million to \$451 million. Even if all the \$262 million in contributions required during the period by the funding standards had been made to the 33 plans, they would still have been underfunded by \$317 million. Benefit increases granted in 27 of the 33 plans in the 5 years before plan termination contributed to the rise in underfunding. The increases were generally being financed over the longest periods allowed by the funding standards and, in some cases, became effective while contributions were waived by IRS

Executive Summary

or unpaid by employers. Because these increases were generally guaranteed, they contributed to the claims against the insurance program. (See pp. 13 to 15.)

Contributions Not Paid

The 23 employers made only about half of the \$262 million in contributions required during the 5-year period. Of the \$127 million in unpaid contributions, 45 percent represented amounts that were not yet due because the required payment date had not been reached before the plans terminated. About 32 percent of the unpaid contributions were overdue; PBGC waived the requirements that another 23 percent be paid. (See pp. 15 to 19.)

Preventing Claims

The 1986 amendments should help the program to the extent that claims from employers that are not financially distressed are prevented. However, 18 of the 23 employers with large claims in 1983-85 would likely have met the amendments' distress standards and been allowed to terminate the plans because they were involved in bankruptcy proceedings or experiencing financial hardship. These employers accounted for 96 percent of the group's claims. (See pp. 20 and 21.)

Raising Employer Liability

Before the amendments, PBGC recovered or expected to recover 14 percent of the claims from the 23 employers terminating underfunded plans. The recovery was low because employers had little or no net worth and liability for claims was limited to a percentage of available net worth. Also, employers causing large claims were generally bankrupt, and PBGC's claims had a low priority (unsecured creditor status) in bankruptcy proceedings. (See pp. 21 and 22.)

The 1986 amendments, by raising employers' liability to 75 percent of unfunded benefits, should increase PBGC's recoveries. However, a significant increase in recoveries appears doubtful if most employers terminating underfunded plans continue to be bankrupt. (See pp. 22 and 23.)

Raising Revenue

The 1986 amendments increased the annual premium rate from \$2.60 to \$8.50 per plan participant. The rate increase is projected to generate an average of \$298 million in revenue to finance the program's current and future costs. Due primarily to large claims from the LTV Corporation's terminated plans, PBGC officials estimated in January 1987 that the deficit was about \$4 billion, three times the previously reported \$1.3 billion.

Executive Summary

About \$446 million a year would be required to retire the newly estimated deficit over 15 years, and other program costs are projected between \$776 million and \$1.5 billion annually. Under these conditions, an \$8.50 premium rate is inadequate. Moreover, annual program benefit payments are expected to be \$650 million within the next 2 years, causing an asset drain that could render the program insolvent by 2002. (See pp. 23 and 24.)

Matters for Consideration by the Congress

The Congress may wish to consider additional changes to enhance the program's long-term financial viability. Such changes include

- raising minimum contribution requirements,
- requiring employers to make contribution payments sooner than 8-1/2 months after year end,
- reducing guaranteed benefits,
- raising the priority of PBGC claims against employers in bankruptcy, and
- raising the premium rate again. (See p. 27.)

Recommendations

In light of the matters for congressional consideration, GAO is making no specific recommendations to PBGC or IRS.

Agency Comments

PBGC substantially agreed with GAO's analysis of the causes of large claims and the potential effects of the 1986 amendments on the insurance program. PBGC said that other changes, such as tightening the conditions under which funding waivers are granted, should also be considered for improving the program's financial condition. (See app. II.)

IRS expressed concern about the limited scope of GAO's study. IRS commented that adequate information was not developed to (1) present a complete picture of the situation involving funding waivers or (2) make overall judgments about changes in the funding standards. Although GAO's study did not include plans that received waivers and did not terminate, GAO believes that it is adequate to show the impact of waivers on claims incurred by the insurance program. Because the study covered 90 percent of the fiscal year 1983-85 program claims, GAO believes that it affords a reasonable basis for suggesting that the Congress consider changing the funding standards. (See app. II and III, and pp. 29 and 30.)

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 Abbreviations

ERISA	Employee Retirement Income Security Act of 1974
GAO	General Accounting Office
IRS	Internal Revenue Service
PBGC	Pension Benefit Guaranty Corporation
SEPPAA	Single Employer Pension Plan Amendments Act of 1986

Introduction

A single employer defined benefit pension plan pays a specific retirement benefit, generally determinable in advance by a formula, to employees of the employer sponsoring the plan. The Employee Retirement Income Security Act of 1974 (ERISA) established funding standards and an insurance program to help ensure that employees and their beneficiaries (participants) receive their earned benefits. The program covers about 110,000 plans with about 30 million participants.

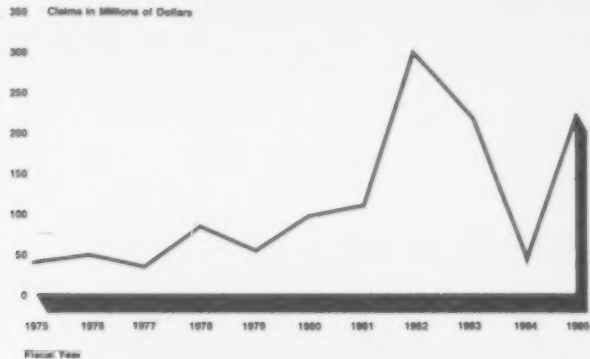
The funding standards require employers to contribute minimum amounts annually to their plans unless they receive a contribution waiver from the Internal Revenue Service (IRS), which enforces the standards. The insurance program, which is administered by the Pension Benefit Guaranty Corporation (PBGC), guarantees, within certain limits, participants' vested benefits at plan termination.¹ When plan assets are not sufficient to cover guaranteed benefits, PBGC assumes responsibility for paying these benefits by becoming plan trustee. Such unfunded but guaranteed benefits are counted as a claim against the program at the time that the liability is assumed by PBGC.

Program's Claims Experience

PBGC's data show that, during the program's first 11 years (1975-85), 922 employers terminated 1,115 pension plans that did not have enough assets to pay guaranteed benefits to about 160,000 insured participants. Claims from these plans totaled about \$1.3 billion. By contrast, about 67,000 plans terminated during this period with enough assets to pay guaranteed benefits.

As shown in figure 1.1, annual program claims from 1975 through 1985 varied in size—from a low of \$32 million in fiscal year 1977 to a high of about \$296 million in 1982. However, the trend in the annual amount of claims was increasing during the period, with about 64 percent of total claims occurring in fiscal years 1982-85.

¹ERISA requires plans to provide that participants will, after meeting certain requirements, retain a nonforfeitable right to the benefits they have earned even if they terminate employment with the plan sponsor before retirement. Such nonforfeitable benefits are called vested benefits.

Figure 1.1: Insurance Program Claims
(Fiscal Years 1975-85)

Our analysis of PBGC's data showed that, during fiscal years 1983-85, 205 employers terminated 241 underfunded plans, leading to claims of about \$501 million. Table 1.1 shows the breakdown of this group.

Table 1.1: Size of Insurance Claims by Employers and Claims Amount
(1983-85)

Claim size	Dollars in millions			
	Employers		Claims	
	Number	Percent	Amount	Percent
Over \$25 million	5	2	\$362.6	72
Over \$2 million to \$25 million	18	9	87.9	18
\$2 million or less	182	89	50.8	10
Total	205	100	\$501.3	100

Program's Financial Condition

Claims dollars that are not recoverable from employers terminating plans are considered to be net claims (losses), which must be financed by premiums paid to PBGC by ongoing insured plans. Since its inception, the program has operated at a deficit; that is, its losses and administrative costs have exceeded premiums paid. As of September 30, 1985, the program reported a deficit of \$1.3 billion (liabilities of \$2.7 billion minus assets of \$1.4 billion), including a liability for a pending claim of over \$400 million for plans that were later terminated by the Wheeling-Pittsburgh Steel Corporation in November 1985.

During 1986, PBGC estimated that, initially, premium income and investment return would be enough to cover the program's annual costs—benefit payments to participants and administrative expenses. Eventually, however, program costs were expected to exceed income and drain program assets. PBGC estimated that, by the year 2002, the program would be insolvent—not have enough assets to pay annual program costs—if the then premium rate of \$2.60 was not increased.

PBGC proposed legislative actions, including a premium rate increase, to improve the program's financial condition. The Single Employer Pension Plan Amendments Act of 1986 (SEPPAA), enacted April 7, 1986, included provisions similar to those proposed by PBGC. As discussed in chapter 3, however, the insurance program's financial condition has weakened further since SEPPAA's enactment.

Objectives, Scope, and Methodology

On February 12, 1986, the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, asked us to provide information on the extent of plan underfunding and causes of large insurance claims from plan terminations. On June 24, 1986, we testified on these subjects during a hearing held by the Subcommittees on Oversight and Social Security. In a report entitled *Pensions: Plans With Unfunded Benefits* (GAO/HRD-87-15BR, Oct. 22, 1986), we gave the Chairman of the Subcommittee on Oversight more detailed information on the extent of plan underfunding in ongoing plans.

As agreed with the Subcommittee, this report primarily provides more detailed information related to (1) the causes of 23 employers' large claims² (over \$2 million) during fiscal years 1983-85 and (2) the potential effects of SEPPAA on claims and their financing. These employers, as noted in table 1.1, accounted for 90 percent of the claims dollars by terminating plans between 1983 and 1985. Our audit work was primarily done between February and September 1986.

To identify the causes of large claims, we interviewed officials of PBGC and IRS and reviewed data maintained by these agencies on the 33 plans terminated by the 23 employers. We also reviewed pension plan reports filed by plan administrators with the Department of Labor. Where appropriate, we interviewed plan representatives (primarily actuaries)

²For purposes of this study, we considered all plans terminated by an employer to be a single claim. The 23 employers terminated a total of 33 plans. Appendix I contains descriptive information on the 35,000 participants in the 33 plans.

and requested plan records that were not available at the government agencies. Our analysis of plan data was limited to the 5-year period before the plans terminated because earlier data were generally not available.

Because SEPPAA was enacted so recently, sufficient time had not elapsed to measure its effects on the insurance program. Therefore, we used the data collected on the large claims from the 23 employers, along with other available information, to get an indication of the potential effects of selected major provisions. Our analysis was based on a comparison of what happened before SEPPAA and what might have happened if the act had been in effect when the large claims occurred.

To ensure compliance with the disclosure provisions of the Internal Revenue Code, we have not identified, by name, the 23 employers in this report. We do, however, identify three other employers who terminated large underfunded plans in fiscal years 1986 and 1987 because the information discussed in this report on their terminations is publicly available and thereby not covered by the disclosure provisions. This review was performed in accordance with generally accepted government auditing standards.

Chapter 2

Causes of Large Insurance Program Claims

Our review of the 33 terminated plans that caused 90 percent of the claims dollars against the insurance program during fiscal years 1983-85 showed that their unfunded benefits almost doubled during the 5 years before termination.¹ As shown in table 2.1, 44 percent of the plans' total vested and generally guaranteed benefits were unfunded at the start of the period. At termination, the plans' guaranteed benefits were 66 percent unfunded.

Table 2.1: Plans' Funded Status at Termination Compared to 5 Years Before Termination

Funding status	Dollars in millions			
	Five years before termination		At termination	
	Amount	Percent	Amount	Percent
Unfunded	\$232.3	44	\$450.5	66
Funded	298.1	56	227.7	34
Total benefit liability	\$530.4	100	\$678.2	100

Of the \$451 million in unfunded guaranteed benefits at termination, about

- \$317 million (70 percent) resulted from minimum contributions permitted by the funding standards being insufficient to pay for the plans' rising unfunded benefits by the time they terminated, and
- \$134 million (about 30 percent) resulted from minimum contributions computed under the funding standards not being paid at plan termination.

We identified several factors contributing to the increased underfunding during the 5 years before termination.² Although we were not able to quantify the dollar effect of all of the factors, we believe that each contributed significantly to the underfunding of the 33 plans. We noted, for example, that the plans were frequently amended to increase benefits during the 5 years before termination and most of the increases were guaranteed by the insurance program at plan termination. Moreover, of the unpaid minimum contributions at termination, more than half represented those that were overdue (32 percent) and those that had been

¹The funded status at termination is based on PBGC's valuation of the plans' assets and guaranteed vested benefits. The funded status 5 years before termination comes from plan reported figures that were mostly based on long-term interest rates lower than the rates available when the plans actually terminated. To make the two sets of figures comparable, we recalculated the plans' reported vested benefits at PBGC interest rates available at plan termination.

²Our analysis of the 33 plans showed that the decrease in funds from \$298.1 million to \$227.7 million was caused primarily by the decline in employer contributions while benefit payments to retirees continued.

waived by IRS (23 percent). The remainder (45 percent) represented contributions for plan periods just before termination that came due as a result of termination.

Funding Standards and Guaranteed Benefits

ERISA's funding standards require an employer to make annual minimum contributions to a plan based on one of several funding methods and on assumptions concerning future plan costs. The funding method determines how contributions needed to pay for a plan's benefits will be spread over future years. Assumptions about mortality rates, employee turnover, compensation levels, and investment earnings are used to project plan assets and benefits.

An employer's minimum contribution generally includes a plan's estimated (1) current year costs and (2) amounts needed to pay off its unfunded liabilities over specified future periods. Unfunded liabilities arise when benefit improvements are granted to working participants for their past service or to retirees (e.g., cost-of-living increases), when assumptions are changed, or when plan experience differs from that anticipated. Increases in unfunded liabilities caused by assumption changes and unanticipated experience can generally be paid off under the funding standards over maximum periods of 30 and 15 years, respectively.

Unfunded liabilities caused by past service benefit improvements can also be paid over 30 years. This long-time financing provides an incentive for employers to establish and maintain defined benefit pension plans and to provide benefit increases that might not otherwise be affordable.

Under ERISA and IRS regulations, employers are not required to make annual contributions until 8-1/2 months after the end of the plan year. If a plan terminates, however, unpaid contributions generally come due as of the termination date. An employer may request, and IRS may authorize a waiver of all or part of the required annual contribution if (1) the payment cannot be made without the employer incurring a substantial hardship, and (2) the waiver is in the best interests of plan participants (e.g., the waiver may allow the employer and the plan to continue). Waivers are not permitted for more than 5 of any consecutive 15 years. Amounts waived must be repaid within 15 years.

The insurance program guarantees participants' vested benefits at termination within certain limits. Benefit increases within 1 year of plan

termination are not insured. Increases in effect for longer than 1 year but less than 5 years are phased in at a rate of 20 percent of the increase or \$20 of monthly benefit, whichever is greater, for each additional year that the increase has been in effect. Generally, all benefit increases are fully insured after 5 years.

Required Contributions Insufficient to Fund Guaranteed Benefits at Termination

The minimum funding standards were designed to provide reasonable assurance that an ongoing pension plan will systematically accumulate sufficient assets to pay benefits to participants and their beneficiaries as they come due. The standards do not, however, assure that a plan's vested (generally guaranteed) benefits will be fully funded in the event of plan termination. Furthermore, the standards do not prohibit a plan's unfunded vested benefits from growing over time.

The information available on the 33 plans terminated by the 23 employers indicated that, although almost all minimum contributions had been paid by employers as of 5 years before plan termination, the plans' vested benefits were underfunded at that time by a total of \$232 million. Further, even if all of the additional \$262 million in contributions required for the subsequent 5 years had been paid, the plans would still have been underfunded at termination by about \$317 million—a 37-percent increase in unfunded benefits during the period.

A plan may operate with large unfunded vested benefits for a variety of reasons even though minimum contribution requirements computed under the funding standards are being met. Some funding methods, for instance, result in slower asset accumulation than others. Unfunded benefits may also arise when a plan's actual experience is less favorable than previously assumed (e.g., earnings from investments may be lower than anticipated). Further, benefit improvements can cause underfunding because vested benefits are increased immediately while their funding can be spread over future plan years. These improvements include both plan amendments raising benefits for participants' past service and salary increases in plans with salary-based benefit formulas.

Another source of underfunding occurs in plans that provide special supplemental benefits—frequently called shutdown benefits—in the event of plant closings. According to PBGC, these benefits generally are not prefunded but may be insured by the insurance program.

We generally could not identify or precisely quantify the extent to which each of these reasons contributed to plan underfunding at termination because of the limited historical plan funding and participant information available on the 33 plans covered by our review. We found indications, however, that benefit improvements during the 5 years before plan termination contributed significantly to increased plan underfunding.

The gradual funding of benefit improvements is not a major concern as long as plans continue. However, such funding of increases can produce larger insurance claims if contributions are not sufficient to pay for the increases by the time plans terminate.

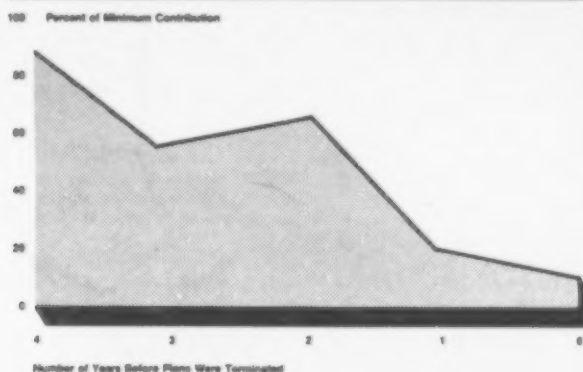
In this regard, we found that 27 of the 33 plans were amended to increase benefits during the 5 years before their termination and most of the increases were guaranteed at termination.³ Benefits were increased in 16 of the plans three or more times during the period, and increases in 17 plans became effective while contributions were waived or unpaid. Also, when employers made contributions in the 5 years before plan termination, most contributed at the minimum levels required under the funding standards. Therefore, even when required contributions were being made in full, the plans' unfunded benefit liabilities, including those resulting from benefit increases, were being funded over the longest periods allowed by the funding standards.

Required Contributions Unpaid at Termination

As figure 2.1 shows, the percentage of minimum annual contributions determined under the funding standards that were paid to the 33 plans by the 23 employers sponsoring them declined significantly during the 5 years before their termination. These unpaid contributions caused \$134 million (about 30 percent) of the plans' \$451 million in claims against the insurance program.

³Of the six plans that were not amended to increase benefits, three had salary-based benefit formulas.

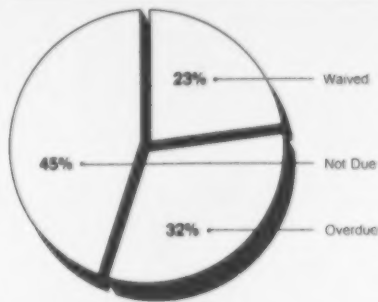
Figure 2.1: Decline in Ratio of Actual to Minimum Contributions to 33 Plans Within 5 Years of Plan Termination



The \$134 million consisted of \$127 million in unpaid contributions by 20 employers sponsoring 30 of the plans and about \$7 million in interest on the unpaid amounts. The \$127 million represented about 54 percent of the \$235 million in total contributions required from these 20 employers for the 5-year period.

As figure 2.2 shows, overdue contributions and contributions that had been waived by IRS accounted for significant percentages of the \$127 million in unpaid contributions. Contributions that were not due before termination, but became due because of termination, accounted for the most significant percentage and amount—45 percent and about \$57 million.

Figure 2.2: Causes of Unpaid Minimum Contributions at Plan Termination



Unpaid Contributions Not Due Until Termination

Of the 30 plans with unpaid contributions at termination, all had contributions that did not become due until termination. These unpaid amounts totaled about \$57 million. The 20 sponsoring employers owed \$35.4 million to the 30 plans for the partial year of termination. Twelve of the employers also owed \$21.5 million in contributions to 17 plans for the prior year. These contributions had not come due because the plans were terminated before the required payment date—8-1/2 months after the end of the plan year.

The unpaid contributions covered an average of 14 months of plans' operations, ranging from 1 month to 20 months. The 20 employers owed contributions at plan termination ranging from \$94,000 to \$24.4 million.

For example, an employer terminated a plan in July 1985 without making a \$15.6 million contribution for plan year 1984, which ended on December 31, 1984. (The contribution was not due until September 15, 1985.) Also, an \$8.8 million contribution for the first 7 months of plan year 1985 came due at plan termination. As a result, the employer at termination owed \$24.4 million in contributions and \$1.1 million in interest on the unpaid contributions for the prior 19-month period.

**Required Contributions Not
Waived or Paid**

At the termination of 21 plans sponsored by 12 employers, \$41 million in unpaid contributions were overdue because the 8-1/2-month period had elapsed. The contributions were overdue by an average of about 14 months at plan termination. Nine of the employers had requested waivers on some or all of the contributions, but some requests were later withdrawn and IRS had denied or not yet reached a final decision on the other requests by the time the plans were terminated. The other three employers had not requested waivers for \$7.4 million in unpaid required contributions.⁴ The 12 employers included:

- An employer who requested a waiver for \$5 million in contributions for two plans' previous plan year of operation on the last day of the 8-1/2 months after the end of the year. The plans were terminated shortly after IRS denied the waiver request.
- An employer who did not make required contributions for 2 consecutive plan years. The employer did not request a waiver for either year, according to IRS records, and the plan was eventually terminated with \$6.4 million in unpaid required contributions for the 2 years.

**Plans Terminated Before
Waived Contributions Were
Repaid**

Nine employers had about \$29 million in unpaid waived contributions to 15 plans at termination. IRS had approved waivers for these employers' contributions ranging from \$315,000 to \$8.3 million. Four employers received waivers for a single plan year, while five employers received them for 2 years or more. Each employer was required to repay the waived amounts with interest over a 15-year period. When the plans later terminated, unpaid amounts, except for \$800,000 for two employers, came due immediately based on agreements reached between IRS and the employers as a condition of waiver approval. Such an agreement was not included in the waiver approvals for the two employers because IRS did not believe such a condition was needed at that time. Eight employers made partial payments before terminating their plans. The original amounts waived for these eight employers were not reduced at plan termination because of interest charges on the waived contributions. The nine employers included:

- an employer who received waivers for \$6.1 million in minimum contributions owed to two plans for the years 1981 and 1982. After a few payments, the employer ceased all contributions. When the plans were

⁴The scope of our review did not cover the circumstances surrounding the overdue contributions. However, we plan to review pension contribution requirements and IRS's administration of them in a later study.

Chapter 2
Causes of Large Insurance Program Claims

terminated in 1985, the unpaid contributions had grown with interest to \$6.8 million and accounted for 22 percent of the plans' underfunding of \$31 million.

- an employer who received a waiver for \$315,000 for a single plan year. The employer terminated the plan shortly after the waiver was approved and did not make a payment. The waived amount with interest accounted for 10 percent of the plan's \$3.8 million underfunding at termination.

Chapter 3

Potential Effects of 1986 Amendments on Program's Claims and Financing

As of September 30, 1985, the insurance program had a \$1.3 billion deficit. Based on preliminary data, program officials have estimated that the deficit would be at least \$1.8 billion at the end of fiscal year 1986. As of January 1987, the deficit was estimated to be about \$4 billion primarily because three plans of the LTV Corporation were terminated with estimated claims of about \$2 billion.

A major objective of SEPPAA was to strengthen the insurance program's financial condition. SEPPAA included provisions designed to (1) prevent claims from plans terminated by employers who are not financially distressed, (2) increase recovery of claims from distressed employers by raising their liability for unfunded benefits, and (3) raise premium revenue by increasing the premium rate paid by ongoing plans.

These amendments should help prevent claims from some underfunded plans and better finance claims that do occur. However, these positive effects may not be enough to ensure the program's long-term financial viability. Most of the claims dollars during fiscal years 1983-85 came from financially distressed employers, and PBGC expects the recovery of claims from such employers to continue to be low, even with SEPPAA's increased employer liability. Furthermore, considering current and expected future conditions, the higher premium revenues will not be adequate to retire the program's current deficit, much less pay for future program costs.

Preventing Claims From Nondistressed Employers

Before SEPPAA, any employer could cause a claim against the program by voluntarily terminating an underfunded plan. Now, employers can terminate underfunded plans only if they

- are in bankruptcy liquidation or reorganization, or other insolvency proceedings, and have court approval of the termination;
- do not have the ability to pay debts and continue in business; or
- have unreasonably burdensome pension costs due to a declining work force.

These standards should help the program prevent claims from employers who are not financially distressed. However, large claims in the past have primarily come from financially distressed employers. Should this trend continue, SEPPAA's provisions may not result in significantly lower claims.

As table 3.1 shows, 17 of the 23 employers with large claims in 1983-85 would have met the distress standards because they were involved in bankruptcy proceedings. These employers' plans accounted for \$258 million (57 percent) of the total \$451 million in claims from plans terminated by the 23 employers. Further, about 90 percent of the remaining \$192 million in claims from the nonbankrupt employers was caused by one employer who may have met the standards if they had been in effect at the time of plan termination. According to information provided to PBGC by the employer, it had a declining work force and a highly questionable ability to continue to pay debts and meet pension obligations. In total, these 18 employers' claims accounted for \$431 million (96 percent) of the \$451 million in claims.

Table 3.1: Operating Condition of
Employers Causing Large Program
Claims (1983-85)

Operating condition	Employers		Claims	
	Number	Percent	Amount	Percent
Reorganization in bankruptcy	14	61	\$233.7	52
Liquidation in bankruptcy	3	13	24.7	5
Ongoing	4	17	187.1	42
Out-of-business	2	9	5.0	1
Total	23	100	\$450.5	100

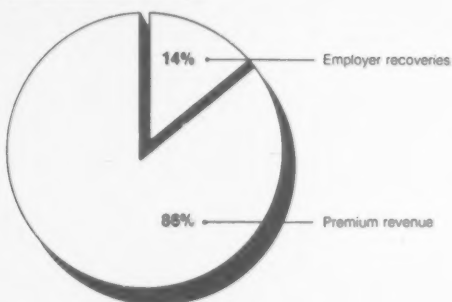
Raising Employer Liability for Claims

Before SEPPAA, PBGC as an unsecured creditor could seek to recover any unpaid contributions from an employer at plan termination. Recovery could also be sought for any remaining claim, but was limited to 30 percent of the employer's net worth.

As shown by figure 3.1, as of January 1986, PBGC had recovered or expected to recover 14 percent (\$64 million) of the total claims of \$451 million from the 23 employers. This relatively small recovery amount was the result of unpaid contributions having a low priority (unsecured creditor status) in bankruptcy proceedings, employer liability being limited to 30 percent of net worth, and employers generally having little or no net worth. As discussed above, over half of the \$451 million in claims came from 17 employers who had filed for bankruptcy.

Figure 3.1: Financing of Large Claims Through Recoveries From Employers Terminating Underfunded Plans and From Premium Revenue (1983-85)

Total Claims Were \$451 Million



After SEPPAA, PBGC can still seek to recover any unpaid contributions. SEPPAA authorizes PBGC to recover, as a general (unsecured) creditor, up to 75 percent of a terminated plan's underfunding, even if it exceeds 30 percent of the employer's net worth. The act also authorizes IRS to require that employers provide security as a condition of waiver approval for plan contributions accumulating to \$2 million or more.¹ These changes may help PBGC recover waived contributions from some employers. However, a significant increase in recoveries of any remaining claims from employers in bankruptcy proceedings appears doubtful.

We found that 3 of the 23 employers causing large claims during 1983-85 each obtained waivers for \$2 million or more. If SEPPAA had been in effect, IRS could have required them to provide security for these waivers, which totaled \$16.3 million. According to PBGC officials, recoveries for secured creditors can generally be expected to be at or near the full amount claimed. However, full recovery from the 3 employers would have accounted for only about 4 percent of the \$451 million in total claims from the plans terminated by the 23 employers.

¹ Before SEPPAA, IRS was not precluded under its general authority from requiring employers to provide security as a waiver condition, but according to IRS, it had done so only once.

PBGC expects a low recovery rate from employers even with SEPPAA's increased employer liability. In this regard, the executive director of PBGC, in June 1986, stated that "... although the PBGC can, in theory, recover some of its losses from plan sponsors, most of our claims have only unsecured creditor status in bankruptcy. Consequently, our claims are worth only about 7 to 15 cents on the dollar." We can understand why the expected recovery rate remains low. Although the employer liability for termination underfunding was increased by SEPPAA, claims filed by PBGC for unfunded guaranteed benefits continue to have a low priority (unsecured creditor) in the order of distribution of employers' assets, which are likely to be limited in bankruptcy proceedings.

Raising Premium Revenue

ERISA initially authorized an annual premium of \$1.00 per participant in insured plans to pay claims not recovered from employers who terminated underfunded plans. The premium rate was raised to \$2.60 for plan years beginning in 1978. SEPPAA increased the rate to \$8.50, effective January 1, 1986.

Based on PBGC's estimate of the number of participants covered by the insurance program, the \$8.50 rate should on the average generate about \$298 million in revenue annually over 15 years. This represents an additional \$207 million over the projected revenue at the \$2.60 premium rate.

Despite this tripling of revenue, the program's financial condition is expected to continue to weaken because of recent claims experience and expected low recoveries from financially distressed employers. As of September 30, 1985, the program had reported a deficit of \$1.3 billion, which included a liability for a pending claim of over \$400 million for plans later terminated by the Wheeling-Pittsburgh Steel Corporation.

In November 1986, PBGC officials advised us that, based on preliminary data, the program's estimated deficit, as of September 30, 1986, should be at least \$1.8 billion. Over half of the \$500 million increase from the prior year represented claims from underfunded plans terminated by two bankrupt employers, the LTV and Continental Steel Corporations. In January 1987, three other LTV plans that were underfunded by an estimated \$2 billion were terminated. Taking these terminations into account, PBGC estimated that its deficit increased to about \$4 billion.

Although the \$8.50 premium was enacted less than a year ago, PBGC officials now estimate that premium revenue will not be adequate to retire

Chapter 3
Potential Effects of 1986 Amendments on
Program's Claims and Financing

the single employer program's existing deficit, much less pay for future program claims and administrative expenses. We estimate that annual premium revenues of \$446 million would be needed to retire a \$4 billion deficit over 15 years at PBGC's current interest rates. Projected annual premium revenues, however, are only \$298 million, or 33 percent less than \$446 million. Further, additional revenues would be needed to pay future claims and the program's administrative expenses, which by PBGC's most recent forecasts could range between \$775 million and \$1.5 billion annually.

The program's deficit has not affected PBGC's immediate ability to pay pensions to retired participants in terminated plans because assets received from such plans and revenues from premiums and investments have, so far, exceeded such payments. However, PBGC expects benefit payments to retired participants of recently terminated plans to raise the program's total payments from \$270 million in fiscal year 1986 to over \$650 million within the next 2 years. Considering the projected \$298 million in annual premium revenues, this large increase in benefit payments would cause a significant drain on the program's assets.

PBGC officials expect that the asset drain could cause the insurance program not to have enough money to pay annual program costs (become insolvent) in 15 years. In 1985, PBGC similarly estimated that the program would become insolvent in 2001. However, at that time, the premium rate was \$2.60 and the deficit was \$462 million as of September 30, 1984. As a result, the administration is developing additional legislative proposals to improve the program's financial condition, including the charging of higher premiums to employers that do not adequately fund their plans.

Chapter 4

Conclusions and Matters for Consideration by the Congress

Conclusions

The insurance program's increasing deficit was caused by (1) an increasing trend in claim amounts since the program's inception, (2) low recoveries from employers causing the claims, and (3) inadequate premium revenue from ongoing plans.

In recent years, most of the claims have been caused by a relatively few employers terminating underfunded plans. During fiscal years 1983-85, the large claim amounts resulted primarily from the federal funding standards not requiring sufficient contributions to pay for the plans' unfunded benefits by the time they were terminated.

There are indications that frequent benefit increases during the 5 years before plan termination contributed significantly to the plans' underfunding. The benefit improvements were generally guaranteed by the insurance program. However, they were also typically being financed over the longest periods allowed by the funding standards and, in some cases, became effective while contributions were waived or unpaid.

Large claims also resulted from employers not making minimum annual contributions required under the funding standards in the years leading up to plan termination. Significant percentages of the unpaid contributions either were overdue or had been waived by IRS. Almost half, however, represented contributions covering an average of over a year of plan operations that were not yet due because the payment deadline (8-1/2 months after the end of a plan year) came after plan termination.

Recovery of claims from the employers causing them was low because employer liability was limited to a percentage of their net worth, and the employers typically had little or no net worth and were financially distressed—i.e., in bankruptcy reorganization or liquidation proceedings.

SEPPAA, enacted in April 1986, included provisions that should help prevent some claims and better finance claims that do occur. As designed, the provisions should (1) prevent claims from employers who are not financially distressed by prohibiting them from terminating their underfunded plans, (2) increase somewhat the recovery of claims from distressed employers by raising their liability for unfunded benefits, and (3) more than triple premium revenues by increasing the annual premium rate from \$2.60 to \$8.50 per plan participant.

However, in January 1987, PBOC officials estimated that the program's deficit had increased to about \$4 billion—a considerable increase over

the \$1.3 billion deficit reported as of September 30, 1985. The rise in the deficit was mostly the result of large unrecoverable claims from one financially distressed employer. As an unsecured creditor, PBGC expects its recovery of claims from financially distressed employers to continue to be low. Furthermore, considering current and expected future conditions, the higher premium revenue generated under SEPPAA will not be enough to retire the program's deficit, much less unrecoverable claims from future plan terminations. Also, PBGC estimates that the insurance program will not have enough assets to pay annual benefits and administrative costs in 15 years.

Because SEPPAA's positive steps may not be enough to ensure the program's long-term financial viability, further changes may be needed to control program claims and finance those that do occur.

Matters for Consideration by the Congress

Given the uncertainties associated with the long-term effects of SEPPAA on the program's financial condition, the Congress may wish to consider additional changes to enhance the program's financial viability. To help control potential claims against the program, such changes could include

- raising the minimum contribution requirements to reduce plans' unfunded benefits;
- requiring employers to make contribution payments to their plans sooner than 8-1/2 months after a plan year ends; and
- reducing benefits guaranteed by the program, e.g., eliminating coverage of any benefit improvements that become effective within 5 years of plan termination.

To enhance the financing of claims that do occur, possible changes include

- raising the priority of PBGC's claims against employers that are in bankruptcy proceedings and
- raising the premium rate again to provide the revenue needed to retire the program's deficit and pay for projected unrecoverable claims.

Examples of Potential Effects of Suggested Changes

Changes designed to improve the program's financial condition can directly or indirectly affect employers, plan participants, the federal government, and other private companies. For example, raising the minimum contribution requirements directly affects employers that would have to increase their annual contributions. The impact of such a change

on individual employers would depend on the extent of the increased contributions. Further, such a change could affect participants because it may encourage some employers to hold down pension costs by reducing or eliminating future benefit increases.

Table 4.1 provides additional examples of how our suggested changes could affect different parties.

Table 4.1: Examples of Potential Effects of Suggested Changes

Suggested changes	Potential effects of changes on		
	Employers	Plan participants	Other
Raise minimum contribution requirements	Higher annual costs for some employers, which reduce money available for their other business activities. Minimize premium rate requirements for ongoing insured plans because of better funded plans.	Lower pensions than may otherwise be provided if employers decide to slow or stop benefit increases to reduce plan costs. Loss of defined benefit pension coverage if higher costs encourage employers to terminate plans—offset to some extent by higher wages.	Because contributions are tax deductible, government tax revenue could (1) increase if terminations occur without an increase in other deductible expenses, or (2) decrease if employers increase contributions without reducing other deductible expenses.
Require contributions to be made sooner than 8-1/2 months after plan year end.	Reduced flexibility for financing other business activities. Increases requests for minimum funding waivers. Minimize premium requirements.		
Reduce guaranteed benefits.	More pressure to grant higher wages rather than higher pension benefits during collective bargaining. Minimize premium requirements.	Lower pensions if underfunded plans terminate. Higher wages rather than increased pension benefits in ongoing plans because of collective bargaining trade-offs.	
Raise priority of PBGC's claims in bankruptcy proceedings.	Limit ability to borrow money due to restricted loan covenants, especially during periods of financial distress. Minimize premium requirements.	Lower pensions than may otherwise be provided or loss of defined benefit pension coverage depending on employer's ability to borrow money.	Lower private lenders' and creditors' recoveries from bankrupt employers.
Raise the premium rate.	Higher pension costs for employers sponsoring ongoing plans. Encourage terminations.	Same as changes to contributions.	

Agency Comments and Our Evaluation

In a February 18, 1987, letter commenting on a draft of this report (see app. II), PBGC's executive director expressed substantial agreement with our analysis of the causes of large claims against the potential effects of SEPPAA on the insurance program. She stated that strengthened funding standards are essential to the program's long-run viability and

that accelerated funding is needed for existing unfunded liabilities as well as for future benefit increases. Also, on February 19, 1987, the administration unveiled a proposal to strengthen the funding standards to protect plan participants' benefits as well as the insurance program.

In a letter dated February 27, 1987 (see app. III), the commissioner of IRS commented that our study was limited in scope and did not address funding standards from any perspective other than PBGC's financial viability. He said that our analysis did not provide information sufficient to make overall judgments or recommendations about changes in the funding standards.

Our analysis, which covered plans causing 90 percent of the claims against the insurance program during fiscal years 1983-86, showed that \$317 million (70 percent) of the claims resulted from insufficient contributions permitted by the funding standards. We believe our analysis demonstrates that changes in the funding standards could strengthen the program's financial condition and merit congressional consideration. We agree that the scope of the study was not sufficient to make specific recommendations about funding standard changes and, as a result, we are not making recommendations.

The executive director of PBGC stated that, although our report points out problems caused by minimum funding waivers, it does not cite possible corrective actions as a matter for congressional consideration. She commented that the conditions under which funding waivers are granted should be tightened considerably. The commissioner of IRS stated that the report, although correctly pointing out that many insufficient plans were granted waivers, may not present a complete picture of the situation. He said that more information is needed to assess the impact of waivers on the PBGC deficit and overall funding policy.

The executive director said that funding waivers can defeat the purpose of the funding standards. However, we are not making any recommendations because, as noted by the commissioner, more information than provided by our analysis, which did not include plans that received waivers and did not terminate, is needed to determine whether specific changes are needed in the funding waiver process to protect the program's financial viability.

According to the executive director, shutdown benefits provide a form of supplemental unemployment compensation to plan participants until

they become eligible for social security, but most plans make no provision to fund the benefits before a shutdown. She said that such benefits can immediately double or triple a participant's benefit at the moment a shutdown occurs, resulting in plan assets being consumed faster than contemplated.

The executive director commented that shutdown and other contingent benefits that have become a major factor affecting PBGC's financial condition were not addressed in our draft report. She suggested that one option would be to explore arrangements that could lead to better funding of shutdown benefits. The report has been revised to recognize that the payment of shutdown benefits can contribute to claims against the insurance program. However, we do not address the matter in the report in detail because of the limited data available on the plans covered by our review for measuring the impact of shutdown benefits on the insurance program.

The report suggests that the Congress might want to consider increasing the program's premium rate and points out that the administration is developing a proposal for charging higher premiums to employers who do not adequately fund their plans. The executive director of PBGC commented that such a premium rate structure will be (1) more equitable, charging less to better funded plans, and (2) significant in keeping better funded plans in the defined benefit system.

Appendix I

Characteristics of Participants in 33 Sampled Plans Reviewed

Figure I.1: Status of Participants When Plans Were Terminated

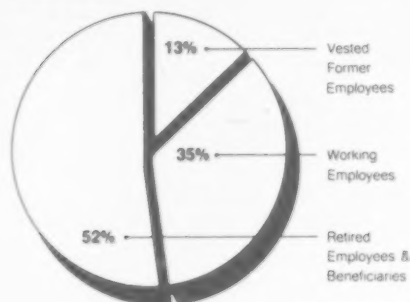


Figure I.2: Number of Participants Eligible to Receive Guaranteed Benefits

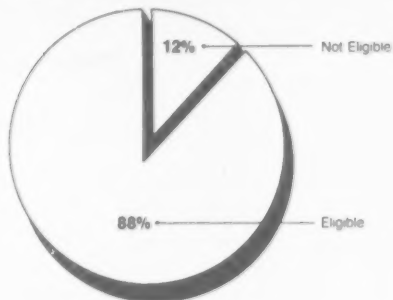


Figure I.3: Union Membership of Plan Participants

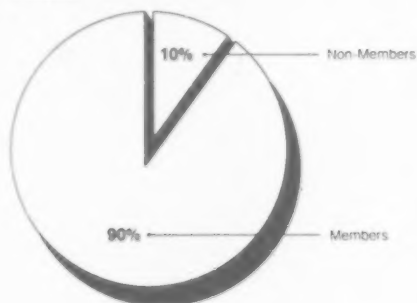


Table I.1: Industries in Which Participants Were Employed

Manufacturing	
Primary metals	38%
Machinery	37%
Fabricated metals	14%
Food products	11%
Other	0%
Subtotal	99%
Mining	2%
Transportation	1%
Wholesale-retail trades	1%
Total	100%

Appendix II

Comments From the Pension Benefit Guaranty Corporation



Pension Benefit Guaranty Corporation

2020 K Street, N.W., Washington, D.C. 20006-1806

FEB 18 1987

Office of the Executive Director

Mr. Richard L. Fogel
Assistant Comptroller General
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

Thank you for the opportunity to review and comment on GAO's draft proposed report on the causes and financing of claims against the Pension Benefit Guaranty Corporation's single-employer insurance program.

The PBGC is pleased that the Congress and the GAO are interested in the effects of pension plan underfunding on the ability of the PBGC insurance program to continue to provide retirement income security. GAO's report makes an important contribution to documenting problems causing PBGC's financial difficulties. The PBGC is in substantial agreement with GAO's analysis of the causes of large claims and the potential effects of the 1986 amendments of the single-employer program.

Our specific comments cover four areas: (1) strengthening the minimum funding standards; (2) waiver of the minimum funding standards; (3) plant shutdown and other subsidized benefits that are not pre-funded and (4) premiums.

Minimum Funding Standards

The draft report suggests the need for strengthening the minimum funding standards to enhance PBGC's financial viability. Specifically, the draft report states that one possible change to the funding standards is "raising the minimum contributions requirements to reduce plans' unfunded benefits, especially those resulting from benefit increases." We agree that strengthened funding standards are essential to the long-run viability of the termination insurance program, and we believe that accelerated funding is needed for existing unfunded liabilities as well as for future benefit increases.

Appendix II
Comments From the Pension Benefit
Guaranty Corporation

Funding Waivers

Although the draft report points out problems that have been caused by minimum funding waivers, no possible corrective actions are cited in the report as a matter for consideration by the Congress. Funding waivers can defeat the purpose of funding standards. The PBGC believes that troubled employers should not borrow from their employee's pension funds but should use traditional credit sources. The conditions under which funding waivers are granted should be tightened considerably.

Shutdown Benefits

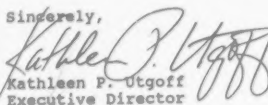
Shutdown benefits and certain other contingent benefits, which have become a major factor affecting PBGC's financial condition, are not mentioned in GAO's report. Shutdown-type benefits provide a form of supplemental unemployment compensation to pension plan participants until they become eligible for Social Security. Most plans make no provision to fund shutdown-type benefits prior to a shutdown event, but such benefits can immediately double or triple a participant's benefit at the moment a shutdown occurs. As a result, plan assets that have been accumulated to provide pension benefits are consumed by benefits that are essentially supplemental unemployment compensation. One option would be to explore arrangements that could lead to better funding of shutdown benefits. Examples of such arrangements could include changing funding standards or establishing separate health and welfare trusts for these benefits to isolate pension plans from unpredictable losses that reflect severance rather than pension benefits.

Premiums

The study notes the PBGC needs greater premium revenue. The Administration has proposed that the premium be changed from a flat rate to a variable rate structure. A variable rate structure will be more equitable, charging less to better funded plans. This improved equity will be significant in keeping better funded plans in the defined benefit system. Employers of well-funded plans should not have to and may eventually refuse to shoulder an unfair share of insurance costs.

We hope our comments will be helpful to you in completing your report.

Sincerely,


Kathleen P. Utgoff
Executive Director

Appendix III

Comments From the Internal Revenue Service

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

FEB 27 1987

Mr. William J. Anderson
 Assistant Comptroller General
 General Accounting Office
 Washington, DC 20548

Dear Mr. Anderson:

This is in response to your request that the Internal Revenue Service (IRS) review and comment on the draft GAO report Pension Plans: Government Insurance Program Threatened By Its Growing Deficit. The report assesses the impact of the current funding standards for defined benefit pension plans on the deficit of the Pension Benefit Guaranty Corporation (PBGC). It also attempts to measure whether the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA) will significantly impact on this deficit.

The report makes recommendations to Congress for changes in the funding standards, bankruptcy laws and PBGC premium rates in order to improve the PBGC's "financial viability." The report makes no recommendations to the IRS or Treasury.

The study itself is limited in scope. It does not address funding standards from any perspective other than the PBGC's financial viability. Further, it bases its conclusions on 33 plans that terminated with unfunded liabilities. While analysis of these plans provides information relating to the PBGC's deficit, it does not provide information sufficient to make overall judgments or recommendations about changes in the funding standards.

The report notes that many insufficient plans were granted funding waivers. Although this statement is correct, it may not accurately present a complete picture of the situation. More information is needed to assess the impact of funding waivers on the PBGC deficit and overall funding policy. For example, one would need to know whether the contributions would have been made if waivers were not granted and how many plan terminations (and resulting increases to the PBGC's deficit) were avoided because of the granting of waivers in other cases.

Department of the Treasury Internal Revenue Service

Appendix III
Comments From the Internal Revenue Service

-2-

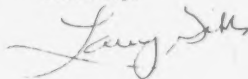
Mr. William J. Anderson

We would suggest that the study's conclusions and recommendations emphasize the limited scope of the study.

We appreciate the opportunity to comment on the report.

With best regards,

Sincerely,



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Chairman PICKLE. Thank you, Mr. Delfico.

I notice that both CBO and GAO have given us some good commentaries on the plan that has been proposed, but both of you contend that you have not had time to analyze the proposal thoroughly. So you have reservations about the overall approach.

Let me ask both organizations, both administrations, to give further comment or analysis to our committee in the immediate week or two ahead if you can, because we are going to try to take this under consideration. Give us some general recommendation in the next 30 days. So while you have not had sufficient time, the time is a bonus and I would like for you all to respond.

Now, I take it both of you have made the point that if you go to the variable rate, with or without additional changes in the flat rate, that this might go a long way toward correcting the financial difficulty we are facing, but does not do anything, basically, or enough, basically, with the problem that we still do not have a rate sufficient to take care of the increased benefits that are growing no matter what is happening.

Is that a basic analysis or a fair analysis? We are approaching it more from a financial stability of the pension fund rather than correcting or making more equal the promise of more benefits that are growing every year higher and higher after a certain rate. How can we check that? What can we do about that?

Mr. DELFICO. Mr. Chairman, I think there are a couple of things we can do. We feel that, first of all, strengthening the minimum contribution requirements is probably more important than approving a variable rate at this stage of the game.

Second, as far as the benefit increases, as we have mentioned earlier—

Chairman PICKLE. When you say the minimum requirements, you are talking about the flat rate, the premium?

Mr. DELFICO. No. I am sorry. I am talking about the minimum contribution for the pension plan, the funding standards issue. I think they are two separate issues: the variable rate issue and the funding standards issues that we have addressed.

We feel that the funding standards issue—that is, increasing the minimum contribution—is extremely important. In our view, it is probably more important to increasing the financial viability of the corporation in the long run than the variable rate, although we do think that they should be combined as a package and considered as a package together.

So those are the two points that we would propose.

Chairman PICKLE. Mrs. Gordon, do you have any comment on that?

Ms. GORDON. Yes. I think that you are exactly right that the PBGC's proposal really has two features. One is that it raises the average premium. It does that in a particular way, and that is why it generates more revenue, although one could certainly consider raising the \$8.50 as well as adding on the extra \$6 per \$1,000.

Economists always like to have incentives going in the right direction, and the variable-rate premium would do that. But as I noted, those incentives are very small. For a firm that is feeling financially pressed, contributing an extra \$1,000 to its pension plan in order to avoid a premium of \$6 seems an unlikely response. That

is why, in fact, to solve the PBGC's problems in the long run, it seems as though having stronger minimum funding standards would be essential to reduce their exposure. Plans would not be allowed to have substantial amounts of benefit obligations that exceeded their assets.

Chairman PICKLE. What kind of transition rule would you have, Mr. Delfico? You said we ought to have a more liberal approach as we increase these premiums. What kind of transition would you recommend?

Mr. DELFICO. We do not have any specifics at this time, Mr. Chairman, but what we would recommend is phasing in the changes that the administration has proposed over a period of time, so that they would not occur immediately.

We estimated, for example, that in one case the premiums paid by an employer in our sample would go up by a factor of 12 if the variable premium rate was in effect. This would affect underfunded plans that are now in trouble, and they could experience that kind of a multiple in the premiums they pay.

Chairman PICKLE. I take it that neither one of you are in opposition to the plan. You said you have not had time to thoroughly examine the proposal, but you are in favor of the general thrust with some cautionary recommendations that we might look into it.

Mr. DELFICO. That is correct.

Chairman PICKLE. But you do not oppose the recommendation, either one of you?

Ms. GORDON. The Congressional Budget Office does not make recommendations, so we can only try to lay out factors for you to think about as you decide what you would like to do.

Mr. DELFICO. We do not oppose in concept both proposals. As a matter of fact, we have in the past testified in favor of both increasing the minimum funding standards and increasing the premium rates.

Chairman PICKLE. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I do not want to put words in your mouth, but to follow along this same theme: Is what you are saying that we should get a good, firm, secure base, and build up that base? That probably should be the main target that we should aim at in the immediate future?

Mr. DELFICO. Yes. We were saying that what you really have to do is build up the base in the pension plans, the underfunded pension plans as they exist today, and make them better funded through better of the funding standards. That may then take care of the premium problem.

Mr. SCHULZE. I presume the two of you were here and listened to my earlier line of questioning regarding the tax ramifications of a loss versus a profitable company. If not, I can go over it again. But if you were here do you have any thoughts on it, and whether that really would give us a level playing field? Are we giving a bonus to an IBM which can take the deduction versus a Bethlehem Steel which cannot? Is that playing field illusionary or is that something that we should seriously consider?

Mr. DELFICO. Well, we have not really looked into that one. We first heard about it this morning, so I really could not comment on it.

I think it should be something to consider. As far as what the outcome would be, I could not venture a guess.

Mr. SCHULZE. Mrs. Gordon, do you have any comment?

Ms. GORDON. No. We would like to think about it and perhaps respond to you for the record.

Mr. SCHULZE. OK. I would appreciate that.

I thank you both for your testimony. It was very interesting.

Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

Mr. Delfico, on page 2 you talk about the 33 plans that you identified and carried through. What does the profile look like? Can you give me a consolidated view of the typical company that we are dealing with here in terms of the reasons for the problem?

Mr. DELFICO. The typical company would be classified as manufacturing, to some degree primary metals—which means iron, steel.

Chris, can you think of anything?

Mr. DOYLE. Yes, 26 of the 33 plans were collectively bargained plans. Most of the plans, perhaps over 30, had flat benefit formulas.

Mr. THOMAS. What I was looking for was some kind of a pattern although you were only in the 1983-85 period. Obviously, in an earlier period, you would have seen perhaps a different segment on the economy, perhaps a different percentage on collective bargaining, perhaps not.

Mr. DOYLE. We would not know.

Mr. THOMAS. We would not know, but I am wondering if there is not a pattern in terms of a company and employees willing to make agreements in a collective-bargaining area on fringe benefits, which may or may not be capable of being paid by a company, but which employees are willing to accept with the understanding that if the company goes out of business, then the Federal Government will be there anyway in an attempt to keep things going.

Is that a totally unfair statement, or is that pure conjecture?

Mr. DELFICO. Well, in our data base, we noted that there were a number of plans that had granted benefits 5 years prior to their termination. I think about 20 percent of the plans, if I am not mistaken.

Mr. DOYLE. It was even more. It was perhaps 80 percent.

Mr. THOMAS. Eighty percent?

Mr. DOYLE. Yes.

Mr. THOMAS. Is that because their social awareness went up in that period? Was something happening in the literature that manufacturers were reading about the need to assist employees?

Mr. DOYLE. No. Those may have been increases that had been occurring in the past, prior to that as well. We do not know. We did not study whether increases occurred before the 5-year period. But these plans, collectively bargained plans, do renegotiate the benefits on a periodic basis anyway.

Mr. THOMAS. Knowing what you know now from that snapshot of 1983 to 1985, what would have been a good response in 1975 to 1980 in anticipation of what was going to occur?

Mr. DELFICO. I think our first response would have been to increase the minimum funding standards.

Mr. THOMAS. Get a little closer to the microphone, please.

Mr. DELFICO. Sure. Our first response would have been to increase the minimum funding standards. With hindsight it seems that would have probably helped about 70 percent of the cases we looked at. Seventy percent of the cases were contributing less than was required to retire their deficit. As a matter of fact, their liabilities were growing as they were contributing the minimum funding required.

The second thing we probably would have done would be to take a look at the 8½ month grace period that plans have to make the contributions. In most of the cases, the remaining 30 percent of the cases we looked at, that had terminated plans had not made their minimum contribution at the time of termination.

So we would have primarily suggested that the minimum funding standard be increased to make them tighter as the administration has proposed.

Mr. THOMAS. Does the administration's plan have a quarterly payment provision?

Mr. DELFICO. Yes, it does.

Mr. THOMAS. That would assist at least in that one aspect which you are talking about?

Mr. DELFICO. Yes, it would.

Mr. THOMAS. What about the 15- versus 30-year amortization that the administration has discussed?

Mr. DELFICO. Our concern there is that there is a movement to spread out the costs over longer and longer periods of time. In the early days of the PBGC, I am not clear on this, but I think they were amortizing costs over 5 years. Under SEPPAA it was 15 years; now it is proposed as 30 years.

What it does is pass on the cost to future generations, and we would prefer to have them stick with the 15-year amortization period.

Now, the down side is that the premium rate would have to be higher than \$8.50, the base rate, to do that.

Mr. THOMAS. You estimate up to \$12.50.

Mr. DELFICO. \$12.50. That is just to retire the deficit.

Mr. THOMAS. But your argument on that would be that the deficit has been accumulated by companies in the recent past. To the extent that we do not heed that lesson and require companies who are currently in to pay, then obviously the companies that are in now are in part paying for past mistakes. And if the time frame is extended, then the burden will fall on far more companies for mistakes that we are not willing to clean up in the short term.

Mr. DELFICO. Exactly.

Ms. GORDON. If I might add to that, I think it is also the case that we know very little about what the future needs for pension insurance coverage will be. As a result, if we take what we know we have to pay for now and spread it out over 30 years, we may wind up having a much higher amount that we need to pay out in the future than we would have if we had taken care of the accumulated deficit now.

Mr. THOMAS. The administration proposes to exempt plans with under 100 employee plans. We saw some indication that percentage-wise it is relatively insignificant. Do you agree with that, or should there be some equity requirement that everybody pay?

Mr. DELFICO. We agree with that.

Mr. THOMAS. Which one?

Mr. DELFICO. From the variable rate standpoint, we agree that exempting plans with less than 100 employees is okay.

Mr. THOMAS. From a collecting point of view.

Mr. DELFICO. But from a minimum funding standards standpoint, as the administration has proposed, all plans will be covered, and we feel that is important.

Mr. THOMAS. Mrs. Gordon, you offered a number of alternatives, and you indicated clearly and correctly that CBO does not make recommendations. But in terms of alternatives on a flat-rate payment, what would be the advantages of that versus a variable rate?

Ms. GORDON. I think that it basically depends on what you believe about who should be paying for pension insurance. If you think that it is very difficult to tell which plans are going to need this insurance and you want to spread the costs as widely as possible, then a flat rate is the way to go.

If, on the other hand, you believe that you have some information about which plans are more likely to lead to claims against the PBGC and there is some evidence that underfunded plans are more likely to lead to claims against the PBGC—then you might want to have the higher premiums targeted to those plans.

Mr. THOMAS. Thank you, Mr. Chairman.

Chairman PICKLE. Mr. Chandler, do you have any questions?

Mr. CHANDLER. If I may, sir.

Chairman PICKLE. Yes.

Mr. CHANDLER. Thank you.

As I try to understand this issue, I am looking again, at the Joint Tax Committee report. They used much of the GAO work, as I understand it, for this report. My question concerns past service liability. When you have a plan amendment that increases benefits, is it that in itself which creates the greater termination liability more than any other factor. Is that correct?

Mr. DELFICO. That is correct.

Mr. CHANDLER. Now, the administration, as I understand it, proposes that the amortization period be reduced from 30 years for that past service liability to something less than that. Is that correct?

Mr. DELFICO. That is my understanding.

Mr. CHANDLER. 3 to 5 years, or something?

Ms. GORDON. I think 3 to 5 years is the minimum amount of time that would be allowed for amortization under the administration's proposal. It could be longer, depending on the extent to which the plan was underfunded, and how soon the plan would have to be paying benefits to retirees.

Mr. CHANDLER. Now, that would clearly improve the funding of these plans, but for purposes of the insurance of benefits in case of a termination, does that answer the problem? Or does something else have to be done?

Ms. GORDON. In the long run, the PBGC's exposure comes from the fact that plans do not have enough assets to meet their obligations. So if you strengthen the minimum funding standards—and reducing the amortization period would certainly be one way to do

that—then the size of the claim that could occur against the PBGC would be reduced.

Mr. CHANDLER. Would it make—I am sorry. Go ahead.

Ms. GORDON. If you merely work in terms of changing the premium structure, you would collect more money for the PBGC so it could pay the claims, but you would not have tackled the other side of getting the claims to be smaller in the future.

Mr. CHANDLER. Well, I think that is something our committee and the Labor Committee ought to address in order to reduce the liability against the PBGC.

Would you suggest that in terms of coverage that perhaps we move back 5 years the level of benefits that would be guaranteed by PBGC? Would that assist? Obviously, it would have in 70 percent of the claims that you cited. Is that correct?

Mr. DELFICO. That is correct.

Mr. CHANDLER. Now, does the administration propose that in its reforms?

Mr. DELFICO. No, not that I am aware of. They do not propose that.

Mr. CHANDLER. Now, Mr. Delfico, did you also suggest that we move to something like 85-percent insurance of the promised benefit? Or did someone else suggest that?

Mr. DELFICO. No, we did not.

Mr. DOYLE. That was Dr. Utgoff.

Mr. DELFICO. We did not suggest that.

Mr. CHANDLER. I am almost tempted to ask a judgment question. Let me pose it and feel free to ignore it if you would like. But it seems that there is very little incentive on either the part of management or labor under the current insurance scheme to avoid adding to a liability, even though the company may be in some difficulty. This is because they know if they terminate, that 100 percent of that benefit is guaranteed. It may well be that some adjustment of what is covered would be in the interest—obviously not those plan participants, but in the interest of the taxpayers that end up footing the bill for this.

Ms. GORDON. One thing to think about is that we are focusing very much on the plans that are going to terminate. Sponsors of other plans have an incentive to put as much money into the plan as possible because the plan's assets accrue at a pre-tax rate. That then provides the opportunity in the future, if the plan has more money in it than it needs, for there to be an asset reversion for the firm.

The 10-percent excise tax for firms engaged in asset reversions in the near future probably does not make up for the loss in tax revenues since firms have been able to shelter their profits in the interim.

Therefore, I think that when you are thinking about ways to change the law, it is important to keep in mind the incentives and the possibilities that we are providing for firms in all sorts of financial conditions.

Mr. CHANDLER. Mr. Chairman, if I may ask one more question, and this one to Dr. Gordon: How in terms of deficit scoring is the PBGC trust fund scored?

Ms. GORDON. The PBGC is partially reflected in the Federal budget. It reflects the revolving fund—into which the premiums and the transfers from the trust funds go—and out of which come the administrative costs and the benefits that are paid by PBGC. Because we have a combination of outlays and inflows that are called negative outlays, the end result has typically been a very small number, often a negative one.

The Federal budget does not reflect the trust fund which receives the assets that the PBGC accumulates when plans terminate. It also does not reflect the liabilities that the PBGC takes on for future benefit payments.

Mr. CHANDLER. Thank you very much, Mr. Chairman.

Chairman PICKLE. I want to make one further commentary. It seems that both of you are recommending that we ought to do something about the minimum funding deficit or weakness. I think it is a valid observation. If there is a reform needed, we have got to not just increase premiums, but also go back to these minimum funding standards.

I do not recall exactly what standard we have now, but the recommendation of the administration has been that we do something about this.

So you are in agreement that we should do something about that, or that should be approached. And I guess the question is the time that you set to do it, the number of years. If I recall, one of you had recommended a lesser time, but are you in general agreement that we ought to require underfunded contributions be made rapidly rather than stretched out flat for 30 years? Do you have any feeling whether it should be just a flat period or should it be up front quicker?

Mr. DELFICO. We feel that they should pay off liabilities as quickly as they are incurred, as far as the minimum funding standards are concerned.

Chairman PICKLE. As soon as they are incurred?

Mr. DELFICO. As soon as they are incurred, yes.

Chairman PICKLE. How soon could that be?

Mr. DELFICO. Well, I would have to make an analysis of that. Depending on the company, there are some employers that are healthy and underfunded. They probably could incur a quicker payoff than other companies that are unhealthy and underfunded. So it would depend on the individual employer in that situation.

Ms. GORDON. I think one thing to bear in mind as you consider the administration's proposal is that it is suggesting quite substantial changes in the standards. If you decide to move in that direction, these changes could be disruptive for some firms. So you may want to consider transition rules to implement them gradually.

Chairman PICKLE. Well, I suppose if we had full funding, if our minimum funding standards would be high enough, it could be the equivalent of full funding and you would not need PBGC.

Ms. GORDON. That is exactly true.

Mr. DELFICO. That is right.

Chairman PICKLE. It does not work that way, does it?

Ms. GORDON. I should say, in good CBO fashion, that if you phase in changes you do get less money for PBGC, or you have more ex-

posure for PBGC in the short run and that does leave you with a larger problem to deal with in the short run.

Chairman PICKLE. I presume that our responsibility as a Congress is to try to set a standard that would be fair, reasonable, and not full funding, but as near to it as we could, and have the PBGC just be the cushion. What that level is, is our problem, but I would agree with you that something needs to be done about the minimum funding. I think you make a good point there.

Well, I thank you both very much. Dr. Utgoff said that different groups might be opposed to the proposal, but you are just making an analysis. So we will look forward now to the next panel.

Our next panel will consist of Mr. Vance Anderson, who is a member of the board of directors, representing the Association of Private Pension and Welfare Plans; Mr. Chester Labedz, chairman of the Title IV Task Force, ERISA Industry Committee; Mr. Richard Fay, chairman of the Employee Benefits Council, U.S. Chamber of Commerce; and Mr. Michael Gulotta, president and chief actuary of the AT&T-Actuarial Sciences Associates, on behalf of the National Association of Manufacturers.

This is quite a group. I will be anxious to hear what you have to say.

We will start off with Mr. Anderson. I believe, Mr. Anderson, you have testified before us previously.

Mr. ANDERSON. Some months ago, yes, sir.

Chairman PICKLE. I will be anxious to hear your testimony to see if you have changed your position any.

STATEMENT OF VANCE J. ANDERSON, MEMBER, BOARD OF DIRECTORS, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. ANDERSON. To my recollection, Mr. Chairman, we were talking about a premium that was due to go to \$8.50, and if I understand the proposal today, we may be looking at a premium that may go as high as \$100 per capita.

Chairman PICKLE. Mr. Anderson, let me ask you to pull that microphone a little closer toward you and speak right into it.

Mr. ANDERSON. Yes, indeed.

Mr. Chairman, I understand that a copy of my prepared statement has been submitted, and I hope it can be entered in the record at this time.

Chairman PICKLE. That will be true of all the panelists.

Mr. ANDERSON. I will then proceed to offer a few salient comments so that we can meet your time requirements.

With respect to the funding proposals offered by the administration, Mr. Chairman, the association believes that from a directional standpoint that we do in fact need to accelerate funding of liabilities for defined benefit plans, and that hopefully if we can embark upon this effort in a quick fashion, we can hopefully eliminate some of the problems we have experienced in the last several years.

In particular the association wishes to lend its support to the administration's proposals to amortize unfunded liabilities and experience gains and losses on a shorter period of time.

We would also be prepared to support a minimum cash flow-related funding standard if in fact it were to work to achieve the same results that are achieved in the multi-employer plan area with a similar requirement there.

Our concern at this time is that the definition of "fully funded" which triggers the imposition of the minimum cash flow requirement appears to require that the plans overstate the true benefit costs and liabilities for the plans.

With respect to the premium proposal itself, Mr. Chairman, let me say that we may be among those groups that are not fully supportive of Dr. Utgoff's proposal. We are appalled at the enormity of the increase being requested by PBGC. Now, if I understand it correctly, they are requesting a \$700 million increase in the premiums to be paid by the ratepayers.

We are mindful of the enormous problems and the burdens that they have to assume, but I would like to point out to you, it is our understanding that from a cash flow basis, that we need not act this year or next; that in fact PBGC is financially solvent to carry itself for a number of years, which will give us time and give you time to carefully consider the implications of this extraordinary increase in the liabilities being assumed by PBGC over the last several years.

We have, Mr. Chairman, as you well know, within the course of 1 short year, gone from a \$2.60 premium to \$8.50 to what is now proposed to be a very large premium.

We are unable at this point, based on our analysis of the premium proposal, to tell you with any clear conviction as to how the variable aspect of this premium will fall. We are troubled by the possibility that plans which today meet the full funding requirement may nonetheless be required to pay a risk-related variable premium under the proposal.

Thank you very much.

Chairman PICKLE. When I asked you to summarize your statement, I did not know you were going to call and raise my offer so quickly. That was a very condensed statement. But I appreciate it, and rather than comment on it now, let us go back. If each of you will do that, that will be helpful.

[The prepared statement follows:]



TESTIMONY OF
THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS
VANCE J. ANDERSON
(Witness)
Employee Relations Counsel, Mobil Oil Corporation
Member, APPWP Board of Directors

Mr. Chairman, Members of the Subcommittee, I am Vance Anderson and I am here today representing the Association of Private Pension and Welfare Plans ("APPWP"), on whose Board of Directors I serve. The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The APPWP's over 400 members represent hundreds of plan sponsors as well as the leading support organizations to benefit plans: investment firms, banks, insurance companies, accounting firms, and actuarial firms.

We are pleased to have the opportunity to share our views on the proposals in the President's Competitiveness Initiative that affect funding and termination of defined benefit plans. We recognize that the proposal is in its early stages and, accordingly, many of our initial reservations may be answered by detail not yet disclosed or transition rules not yet formulated. We welcome the chance to work with the Congress and the Administration to achieve a workable solution to the issues addressed in the proposal.

Introduction

Over the last five years, the financial soundness of the Pension Benefit Guaranty Corporation has been the subject of hearings before this Subcommittee and before other committees in both Houses. In addition, we have often testified before the Congress on the appropriateness of reversions of excess assets from defined benefit plans, and the part that

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reversions play in encouraging the sound advance funding of these plans. Defined benefit plans are the most secure and reliable retirement vehicles of the many kinds of plans that exist today. Defined benefit plans promise a benefit that depends on an employer's ability to make adequate contributions, rather than on the market's ability to perform. Additional security is provided by the existence of the ERISA Title IV insurance system, which backs up the benefit promises if an employer is financially unable to maintain the plan. Employees covered by defined benefit plans have a basis for assessing their financial needs during retirement, because they know in advance the level of their annual lifetime pension benefit. The rate at which they save is often a function of the defined benefit promises made by their employers.

In 1974, many employers were alarmed at the rate at which ERISA required an employer to fund these promises. Today, most employers recognize that this rate is not rapid enough. The correlation between troubled employers and troubled plans is strong. An employer who is not permitted to fund these promises as fully as possible in its productive, successful years is often unable to fund them at all in the lean years. The result has been unacceptably large losses at the PBGC and a very real threat of even larger losses in the future. Although we have some serious concerns with the Administration's proposal for underfunded plans, we are encouraged by the direction of both this initiative, and the

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variable rate premium initiative, as ultimately supportive of defined benefit plans.

In the last dozen years, defined benefit plans have been battered relentlessly with legislative and regulatory change -- the effective lowering of the Code section 415 limits to cure budget ills, and to address perceived over-pensioning; changes in the rules regarding terminations to deal with the abuses inherent in the ERISA Title IV insurance program. Thus, before Congress acts again to change the rules of the game for defined benefit plans, it is important to make very sure that the legislative proposals are critically needed. With respect to underfunded plans, we think the Administration has identified a real problem which I will discuss in detail in a moment. With respect to overfunded plans, however, we are not at all convinced that there is a problem which needs to be addressed at this time, or in this fashion.

There is no reason to believe that the 1984 Administration reversion guidelines and other recent changes in the law, such as the strengthening of the anti-cutback rules, are ineffectual in protecting employees. Defined benefit plans promise a benefit which should not be diminished by the employer through plan amendment, changes in interest rates, or other actions which can leave an employee with less than he or she was promised. Both the Retirement Equity Act of 1984 and the 1986 Tax Reform Act addressed these issues directly. These statutes require an employer to meet its pension promises for so long as the plan is maintained, but they do not require plan

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maintenance, nor do they change a voluntary system into a compulsory one. The 1984 reversion guidelines also address these issues by requiring that an employer obtaining a reversion protect the interests of all employees in the terminating and the ongoing plans. While the guidelines are not perfect and create some economic inefficiencies in "phantom terminations", we do not believe that they should be hastily discarded. Congress may want to consider some refinements now: for example, a requirement that a successor defined benefit plan grant past service credit for all years of service to protect employee expectations and perhaps some restrictions on reversions that an employer may take if it maintains underfunded plans.

The original Labor Department Advisory Council recommendations last year would have permitted withdrawals from ongoing plans in addition to the termination/ reestablishment and spin-off termination transactions permitted under the guidelines. In addition greater incentives would have been provided not to terminate plans. The Administration proposals ignore the possibilities of incentives and focus only on the possible penalties of plan termination. That approach -- over-regulation and undue restrictions on defined benefit plans -- will not inure to anyone's benefit. To the extent that employers decide that defined benefit plans are not worth their cost and burden, all employees will suffer, as they become the risk takers with respect to their retirement security. We believe that any revisiting of the subject of reversions should

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be addressed with full recognition of the dangers of radically departing from the current legal frame work which has encouraged the growth and maintenance of defined benefit plans.

Underfunded Plans

While we may disagree with some of the details in the Administration's proposed minimum funding rules, their premise is consistent with the legislative changes to Title IV in the last Congress, and would further the goal of limiting PBGC's exposure to future large losses. We recognize that further tightening of the amortization periods is necessary and we are interested in working with the Congress to explore whether funding standards that are related to the strength of plan funding can be administered in a relatively simple fashion. Further restrictions on funding waivers are also a positive change; often, the granting of a waiver is simply prolonging the existence of a severely troubled plan.

We urge that Congress consider the PBGC's premium proposals in connection with the minimum funding standards. Discussion of any proposed premium increase should be accompanied by the full disclosure of the PBGC's current financial status and its assumptions for its future needs. After adequate public debate on whether -- and the extent to which -- a premium increase is needed, we would be eager to work with Congress to see if a variable rate premium is a reasonable approach.

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There is another issue to grapple with as well. In the last several years, a handful of employers have shifted enormous liabilities to the PBGC and then left the defined benefit system. If the entire burden of these losses is shouldered by current sponsors of defined benefit plans, these employers will be disproportionately responsible for a problem which might more reasonably be borne by society as a whole. Title IV was never designed to finance the problems created by the basic restructuring of an entire industry. In sum, we look forward to working with you on these issues, for it is incumbent on us to support changes which will stem the losses that the Title IV program has suffered, often from plans fully in compliance with the minimum funding standards.

The Minimum Funding Proposals

As noted earlier, some of the proposals, such as shortened amortization periods, with appropriate transition rules, may both encourage and achieve better funding for badly underfunded plans. However, in the course of fashioning these rules, the Administration proposal redefines the commonly understood definition of fully funded; devises a new set of very complicated amortization rules using this new definition and factoring in the maturity of liabilities; and adds new rules to govern the maintenance of funding and a plan's cash flow. These rules are badly in need of simplification and targetting.

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In our view, "fully funded" should not be defined as 110% of the assets needed to cover all benefits, including those, like early retirement subsidies, which are contingent on events which have not yet, and may never, occur. The proposal needs to fasten on a more realistic definition. We would suggest assets equal to the Form 5500 definition of liabilities without a cushion. If there is evidence that some plans do not realistically value early retirement subsidies, that problem ought to be addressed through clearer direction on what constitutes reasonable actuarial assumptions and not by redefining "fully funded".

We are also very concerned about the new cash flow minimum contribution rule. Because it is keyed off the 110% of all liabilities definition, it would require minimum contributions even where the plan is overfunded on a termination basis. While we recognize that excessive lump sum payments or annuity purchases can strip assets from a plan, the cash flow rule as drafted here is overkill. An overriding minimum contribution, narrowly focussed as in the Multiemployer Act, is a much more rational approach.

We must consider the effect shortened amortization periods will have on new plans and on the granting of benefit increases. The purpose of this proposal should be to strengthen defined benefit plans, and not to make them so onerous to maintain that there will be no new sponsors of such plans in the future. Thus, the rules must be drafted so that employers will not be discouraged from establishing new plans.

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Moreover, without adequate transition rules, industries which are already on the brink of financial insolvency will be dealt the final blow if sudden, far stricter funding standards are enacted.

In addition, we need to keep in mind the additional administrative costs of the new rules and weigh the advantages, if any, of requiring additional calculations -- such as determining plan liabilities as if all contingent liabilities will become accrued benefits regardless of the likelihood of such an event -- against the added costs of calculating liabilities several times for different purposes -- shareholders reporting, funding, FASB, internal corporate reporting, etc. We need to remember that defined benefit plans are long range plans that were intended to be funded over a period of years, rather than fully funded at all times. We should not rush headlong into so over-tightening the standards that defined benefit plans are abandoned in favor of "fully funded" defined contribution plans.

All of these proposals deserve further discussion, in order to fashion appropriate rules. Ultimately, not all of the proposals may be necessary to strengthen underfunded plans. Only a handful of plans are seriously underfunded; yet these rules create uncertainty, higher contribution requirements, earlier due dates and ongoing controlled group responsibility for all plans.

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The Variable Rate Premium

While the details of PBGC's variable rate premium proposal are still not clear, APPWP agrees with the concept of assessing the costs of the risk of future losses on the plan sponsors who are most likely to terminate underfunded plans. Among those sponsors, it appears reasonable that the amount of underfunding in the plan should be correlated to the level of the premium. We also agree that for the most part, amortization of the deficit and the PBGC's administrative expenses ought to be shared by all sponsors of defined benefit plans. The APPWP was particularly pleased that the definition of liabilities in the premium proposal would be the number derived for Form 5500 purposes, rather than some new, artificial definition. We suggest, however, that plans using interest rate assumptions lower than the PBGC's need not be required to revalue liabilities and plans using assumptions within 50 basis points of the PBGC's rate similarly be exempt from the revaluation requirement. In addition, we are not convinced that the fully funded level need be set at 125% of termination liabilities; we suggest a smaller cushion and we would like to work with you on that issue. We are also opposed to the automatic indexing in the proposal. As proposed, the flat-rate part of the premium, initially pegged at \$8.50 would be indexed to wage growth, and the funding charge would be automatically adjusted every three years to reflect any revision in annual net claims and any difference between the actual deficit and the projected deficit. Finally, the \$100

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per participant cap on the premium would be indexed to one and one-half times wage growth. With no control over the assumptions used to calculate the deficit, and no clear picture of the basis that would be used to determine wage growth, we are reluctant to support any kind of automatic adjustments or indexing. Finally, we question whether there exist sufficient program constraints to ensure that severely underfunded plans do not grant benefit increases which become phased-in before they are funded.

Assuming a premium increase is necessary, we are uncomfortable with a premium increase on a flat rate basis. We suspect, however, that the variable rate basis could pose hazards for new plans, for legitimate benefit increases, and for the continued maintenance of those plans which are not now well funded. We would like to continue to explore these and other premium-related issues with you.

Overfunded Plans

We are particularly concerned with that part of the proposal that deals with overfunded plans. As we have testified in the past, we believe that overfunded plans do not pose a risk to the defined benefit system, nor present a problem which Congress needs to address. The Administration proposal suggests that plan terminations are costly and expensive, that they reduce participants' benefit security with respect to future benefit accruals, and that they discourage the employer from granting ad hoc benefit increases or cost of living

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allowances to retirees. We disagree. While plan terminations may be costly, under current law, they provide full benefit security to participants and all of the excess assets to the employer. Some employers may prefer a direct withdrawal approach; few, if any, however, would support the elaborate cathedral that is before you today. Many would like to take advantage of the opportunity to transfer excess pension funding to tax favored retiree health arrangements; few would meet the proposal's requirements for doing so. We were pleased that the proposals would allow excess assets to be transferred to fund retiree health benefits, because we see this as a very appropriate step in the direction of securing retiree health benefits. For the reasons set forth below in more detail, however, the opportunity to make such a transfer under this proposal is too restricted. We also question the need to repeal Code section 401(h), especially since no justification for its repeal has been put forth.

The proposal imposes complex requirements, revised actuarial calculations, and frequency limitations on the amount of excess assets that can be withdrawn, even where an employer only maintains overfunded plans. For example, under the proposal, an employer who decides to replace a defined benefit plan with a defined contribution plan, and who fully vests and annuitizes all participants, as the Code and ERISA currently require, would not be permitted to receive all the excess assets that remain after annuitization, so long as that employer maintains any other defined benefit plan, regardless

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of how well-funded the remaining defined benefit plans may be. The remaining excess assets would have to be distributed among the employer's other overfunded plans. We fail to see any reason for such a result.

Large controlled groups would find the proposal nearly impossible to live with. Some large controlled groups maintain hundreds of defined benefit plans, some of which are collectively bargained, some of which are not, some well-funded, some not. The rules are very complex with respect to these groups, and appear to sanction, and indeed under some circumstances, require, wholesale transfers of assets among plans in a controlled group, in a way that seems quite inconsistent with the exclusive benefit rules of current law. Such transfers might well violate other laws as well, such as overfunding in plans maintained by government contractors, where the government has or could assert a legitimate claim to the excess. Moreover, mergers and acquisitions would be made far more complicated, and would need to take into account phantom excess funding or underfunding in order to price a transaction. Despite the vague promise of "special frequency rules" for sales and purchases of divisions or subsidiaries, an employer would need to carefully time a transaction to coincide with either other business transfers or planned withdrawals in order to ensure that these "limits" are not inadvertently exceeded. In many ways, the proposal is a Catch-22 in this area: if an employer initially takes the full permissible withdrawal in year 1 of a 10-year period, and in year 9, sells

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a division with an overfunded plan, it cannot receive the overfunding because of the "frequency limit" but is taxed on the overfunding transferred, as if it had removed the excess before the transfer.

Many more examples could be given to illustrate our concern that this proposal is ambitious far beyond the scope of any conceivable abuse. Rather than take the time here, we would urge that business groups and labor groups sit down with the relevant government officials and fully explore reasonable rules, with appropriately focussed goals.

Conclusion

We urge you to approach this proposal armed not only with a clear understanding of the importance of defined benefit plans to American workers, but also of the burdens already placed on employers who have chosen to maintain these plans.

The trend toward defined contribution plans has escalated significantly in the last 10 years and shows no sign of slowing. Indeed, 1984 was the first year in which the number of defined benefit plan participants covered under the Title IV insurance system declined. In large part, however, the investment strategy of defined contribution plans is short term, in recognition of the fact that it is the participant who takes the risk. In contrast, defined benefit plans are the single largest accumulation of funds for long term capital formation. These are plans which can afford the investment in American industry's future over the long haul; to the extent

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these plans are discouraged, their investment support is eliminated as well.

In addition, defined contribution plans, as a means of controlling corporate benefit costs, are very attractive. Because contributions are generally based on a percentage of payroll, annual costs are always known. Administrative costs are also much lower than in defined benefit plans, since complicated actuarial valuations are not necessary and complex annuity rules may be avoided. The defined contribution plan may also alleviate protracted recordkeeping -- once an employee is cashed out, there is no obligation to track this employee in the future. The Administration's proposal makes the cost, predictability and administrative burden of defined benefit plans even greater, further skewing the incentives toward defined contribution plans. If enacted in the form in which it has been proposed, you may see large-scale defections from the system. In our view, that result would be tragic. We would hope that by working with staff, rather than their working in a vacuum, we could avoid it.

Chairman PICKLE. The next person, then, will be Mr. Chester Labedz.

**STATEMENT OF CHESTER S. LABEDZ, JR., CHAIRMAN, TITLE IV
TASK FORCE, ERISA INDUSTRY COMMITTEE (ERIC)**

Mr. LABEDZ. My name is Chester Labedz. I am here on behalf of the ERISA Industry Committee today, and I am also Benefits Counsel of Textron, Inc.

I have with me Mark Ugoretz, the executive director of ERIC, and John Vine, of Covington and Burling, counsel to ERIC.

Getting the PBGC back on a sound financial footing can well be likened to trying to fill a swimming pool which has several large holes and from which the water is pouring out. There are at least three factors to be considered: the size of the pool, how to fix the holes, and where to get the water.

Let us look first at the size of the pool. Is its capacity 4,000 gallons, or merely 800? How you fix the holes and where you have to go to get the water both depend on the size of the pool.

Of course, we are talking here about the fact that 80 percent of the PBGC's current \$3.8 or \$4 billion deficit is attributable to the financial problems of several large companies in the steel industry. Many have questioned whether the termination insurance program should be expected to resolve a financial crisis resulting from the bankruptcy of a major portion of a basic U.S. industry.

The issue is more than a pension issue, and ERIC does not have an opinion on it. But you have to know the answer as you plan to fill the pool.

Next let us look at the repairs. Here, we are talking about the administration's minimum funding proposals. Instead of overhauling the existing standards, the administration wants to stick four new patches on—four more complex rules.

During the past 3 years, plan sponsors have been subjected to a barrage of new regulations. The last thing plan sponsors and prospective plan sponsors need is another series of complex rules.

We agree with the administration that repairs are necessary, but ERIC believes that Congress should fashion a more simple and direct approach. For example, it might simply adjust the 30-year amortization period permitted by current law to fund unfunded liabilities. It also should not let the tax deduction limits stand in the way of sound plan funding. These limits should be liberalized.

Third, let us look at where and how to fill the pool. If you only need 800 gallons, your existing resources will suffice. If you do need 4,000 gallons, is it fair to ask your neighbors to provide you with whatever amount you say you need? Don't they deserve assurances that you will first replace the liner, that is, fix minimum funding; that you will not waste water; and that you will apportion your requests among them in the fairest possible manner?

The administration's proposal does not meet these standards. The PBGC is asking Congress to delegate to it control over employer premium payments. ERIC strongly believes that this control over the spigots should remain solely with Congress. Otherwise, the PBGC, on the basis of its own arbitrary interest rate assumptions and its own predictions of future claims, will be given a broad self-

help remedy to resolve its own financial problems without regard to the broader picture considered by Congress.

We also oppose indexing premiums. There is no reason to believe after the minimum funding reforms are in place that the PBGC's liability will increase in proportion to inflation.

A basic principle used to set insurance premiums is the discounting of exposure by risk. The administration's VRP proposal almost completely ignores the risk element. It is as if, in pricing health insurance coverage for you, I assumed you would be afflicted with expensive-to-treat illnesses throughout your life, without taking into account that you are currently healthy and keeping yourself in shape.

We urge you to look carefully at incorporating an objective measure of an employer's financial health into any VRP equation.

In closing let me mention several more important points quickly.

The proposed controlled group rules would interfere seriously with the purchase and sale of companies in the ordinary course of business and would disrupt defense contracts, labor agreements and corporate accounting. Present law as strengthened by SEPPAA last year is more than sufficient.

The proposed VRP methodology threatens some very surprising results. Because of the need to use PBGC closeout interest rates, the 1.25 multiplier, and other factors, healthy employers with healthy plans nonetheless may face premiums many times greater than \$8.50 per head.

Third, there are many catch-22 situations lurking among the funding rules, deduction limits, and the VRP proposal. For example, a funding charge under VRP often would arise when an employer establishes a new plan with vested benefits, provides a cost-of-living increase to retirees, or increases past service benefits. This would be a powerful disincentive to plan improvements and to the creation of new plans.

Fourth, the apparent liberalization of the transfer of asset and withdrawal rules comes burdened with enough new restrictions of its own to make the benefits to employers and employees of this proposal elusive.

Last, the proposed expansion of the definition of "termination liability" reopens an issue resolved only last year, and imposes liabilities on employers for benefits that are in no sense vested at the time a plan terminates.

Thank you very much.

[The prepared statement follows:]



THE
ERISA
INDUSTRY
COMMITTEE

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE
TO THE SUBCOMMITTEE ON OVERSIGHT
OF THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON THE
ADMINISTRATION'S PENSION PLAN FUNDING
AND PREMIUM RATE PROPOSALS

April 7, 1987

My name is Chester S. Labedz, Jr. I appear today on behalf of The ERISA Industry Committee, commonly known as ERIC. I also serve as Benefits Counsel to Textron Inc.

ERIC is an association of more than 100 of the Nation's largest employers concerned with national retirement and benefit issues. As the sponsors of pension and savings plans covering some ten million participants and beneficiaries, ERIC's members share with the subcommittee a deep interest in the success and expansion of the private pension system.

Over the years, ERIC has devoted thousands of hours and committed a substantial portion of its resources to improving the single employer pension plan termination program. Others, including labor and other business groups as well as the members and staff of the Subcommittee and the Administration, also have committed substantial time and energy to this endeavor. Only last year, as a result of these efforts, Congress enacted the Single-Employer Pension Plan Amendments Act of 1986 ("SEPPA"), which was designed to strengthen the single employer termination program.

ERIC also has a long-standing and serious commitment to the sound funding of private pension plans. This commitment is based on ERIC's recognition of the vital role that the private pension system plays in providing retirement security for our Nation's workers and on the realization that private pension plans will not be able to fulfill that role unless they are funded sufficiently to deliver the benefits they promise.

INTRODUCTION

Over the past several years, we have testified on plan funding and benefit security. For the record, we reiterate several observations we have made in the past.

First, sound pension funding requires an employer to fund pension benefits for its employees many years in advance of the time that the employees actually retire. If an employer could not fund its employees' pensions in advance, the security of its employees' pensions would depend on the employer's financial condition after the employees retire. Adequate advance funding for pensions was a primary goal of ERISA.

Second, the termination of an underfunded pension plan can have serious adverse consequences for the employees and beneficiaries covered by the plan; for the employer that sponsors the plan; for the Pension Benefit Guaranty Corporation ("PBGC"), which insures benefits under terminated plans; and for the other plan sponsors that pay premiums to the PBGC.

Third, although the PBGC insures certain benefits under terminated plans, not all plan benefits are covered by PBGC insurance. Thus, a plan termination can cause employees and beneficiaries to lose a portion of the benefits that the plan had undertaken to provide. To the extent that PBGC insurance applies, the PBGC must cover the cost of unfunded benefits by attempting to collect employer liability payments from the employer that sponsored the plan and by collecting mandatory annual premium payments from the employers that sponsor plans that have not terminated. Thus, ERIC's members, as the sponsors of on-going pension plans, have a strong interest in the sound funding of both their own plans and the plans of other employers.

Fourth, the private pension system is a voluntary system. Thus, any funding standards that make unreasonable financial demands on plan sponsors will discourage the formation and expansion of pension plans in the future. Excessively rigid funding standards also could cause the termination of many existing plans. As a result, minimum funding standards must strike a proper balance between the need for pension plans to be soundly funded, on the one hand, and the need to preserve and expand the voluntary private pension system, on the other.

Fifth, any unwarranted increase in termination insurance premium levels, any unnecessary restrictions on a plan sponsor's ability to dispose of segments of its business, and any rules that make it more difficult for an employer to terminate a plan that has met all of its benefit commitments will damage the private pension system by making it unduly burdensome for employers to adopt and maintain voluntary pension plans, thereby making it unlikely that they will do so.

It is in this context that we offer the following observations on the Administration's "Proposal on the Funding and Termination of Defined Benefit Pension Plans" (the "Funding Proposal") and its "Proposal for a Variable-Rate Premium" (the "VRP Proposal").

MINIMUM FUNDING STANDARDS

The Administration's Funding Proposal recommends a number of measures that are designed to strengthen ERISA's minimum funding standards. ERIC strongly supports the Administration's emphasis on funding as a primary means of strengthening the benefit security of plan participants and of reducing the potential liability of the PBGC.

In recent years, it has become apparent that the existing funding standards do not always provide adequate assurance that a plan will be sufficiently funded. For example, a number of plans that have met the minimum funding standards have nevertheless terminated in a substantially underfunded condition. The burden of the underfunding has been borne both by plan participants and by the sponsors of other defined benefit plans, who have been required to bear substantially escalating payments to the PBGC in order to shore up its financial condition.

While ERIC agrees that strengthening the minimum funding standards is in order, ERIC cannot support the specific measures proposed by the Administration. Instead of proposing revisions in the existing funding standards, the Administration recommends that Congress engraft upon those standards several layers of additional standards, including --

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- (1) special minimum funding rules for a plan with a "Funded Ratio" of under 100%;
- (2) complex amortization rules that would be based on the plan's Funded Ratio and the maturity of its liabilities;
- (3) a Funded Ratio maintenance rule; and
- (4) a cash flow rule.

Although the Administration's Funding Proposal requires considerable amplification before it can be fully understood, it is apparent, even from the general terms of the Proposal, that the measures proposed by the Administration are unnecessarily complex. During the past three years, plan sponsors have been subjected to a barrage of new regulations under the Deficit Reduction Act, the Retirement Equity Act, the Single-Employer Pension Plan Amendments Act, the Tax Reform Act, and the Omnibus Budget Reconciliation Act. The last thing we need is yet another series of complex rules.

We believe that Congress should fashion a more simple and direct approach. For example, Congress might consider simply adjusting the 30-year amortization period permitted by current law. In addition, ERIC is examining other specific approaches.

Congress also should focus on striking a better balance between the required amortization periods (for funding and deduction purposes) and the five-year phase-in of benefits guaranteed by the PBGC. It is not appropriate to phase in the PBGC's guarantee over a five-year period, while permitting 30-year amortization of past service liabilities and imposing tax penalties on an employer that amortizes its past service cost over less than ten years. This issue can be addressed by shortening the minimum amortization periods under the funding standards and tax deduction rules, by lengthening the PBGC phase-in period, or by a combination of these approaches.

ERIC also believes that Congress should not allow the tax deduction limits to stand in the way of sound plan funding. The Administration's Funding Proposal would allow an employer to deduct a contribution to the extent that it did not either cause the plan's assets to exceed the plan's termination liability or cause the assets in all plans of the controlled group to exceed the total termination liability of the controlled group's plans. ERIC believes that the concept of allowing funding up to a plan's termination liability is a sound concept, but opposes the imposition of the controlled group limit.

Because their sales and net income are subject to the fluctuations of the business cycle, plan sponsors often are able to contribute substantially more to their pension plans in strong financial years than in "lean" years. In the past, the tax deduction limits have prevented employers from contributing more in the years when their financial performance would have supported substantially higher contributions to make up for those lean years. In effect, the existing tax deduction limits have prevented employers from adding to the benefit security of their employees when the employers have been most able to provide that added protection.

The Administration's Funding Proposal, however, still would not permit the employer to anticipate future increases in the plan's liability. It also provides no deduction to an employer who makes a contribution to an underfunded plan when other plans in the controlled group

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currently have assets in excess of their total termination liability. We oppose both of these limitations.

ERIC agrees in general with the Administration's proposed additional limitations on the availability of minimum funding waivers. It is appropriate to clearly limit the use of funding waivers to temporary hardship circumstances. However, it is an inappropriate intrusion on the reality of business circumstances, and potentially harmful to the viability of a particular business or plan, to determine hardship on the basis of a controlled group. ERIC strongly opposes this portion of the Administration's Funding Proposal.

ERIC also has reservations about the Administration's recommendation that an employer's minimum funding contributions be made on a quarterly basis, rather than when the employer's tax return is due, as is now the case. This proposal would interfere with the cash flow needs and normal business operations of many employers. We recommend that Congress focus on what is really important here: the basic funding standards.

VARIABLE-RATE PREMIUM

Strengthening the funding standards should go a long way to improving the financial condition of the PBGC. More rigorous funding requirements will cause plans to be better funded, which will, in turn, reduce potential PBGC liabilities.

In assessing whether it is also necessary to increase the PBGC premium rate to fund the PBGC's existing liabilities, it is important to recognize that approximately 80% of those liabilities are directly attributable to the financial difficulties of several large companies in the steel industry.

Many have questioned whether the termination insurance program should be expected to resolve a financial crisis for which the insurance program was not designed: the bankruptcy of a major portion of a basic U.S. industry. For example, if the liabilities of several bankrupt companies within the steel industry were removed from the PBGC's books, the current \$8.50 premium level would be more than sufficient to amortize the PBGC's remaining liabilities. While ERIC has no position on what measures Congress should adopt to address the problems of the steel industry, we think it is important to point out the extent to which the PBGC's present financial condition is attributable to problems within that industry.

From a conceptual standpoint, while some ERIC members believe that a VRP would be desirable, ERIC members generally agree that the Administration's current approach toward a VRP has significant problems. Three important factors shaping their views on the VRP concept are (1) the magnitude of any premium increase -- both for those who have well-funded plans and for those who do not, (2) the extent to which a VRP is phased in, and (3) the specific factors and types of risks taken into account in determining an employer's premium.

If, for example, Congress decides to defray the pension liabilities created by several bankrupt companies in the steel industry through a mechanism other than increased premium payments, the PBGC's unfunded liability will be substantially reduced, and the differential between the highest and lowest rates under a VRP structure also would be reduced. In addition, if a VRP is phased in over a period that gives plan sponsors sufficient time to implement fully

any new funding standards that Congress might adopt, the ultimate impact of a VRP might be significantly reduced: the sponsors of plans that today are not strongly funded will be able to increase their plan contributions and thereby strengthen their plans' funding before any VRP would become fully or even partially applicable.

We stress the close relationship between the Funding Proposal and the VRP Proposal. They have the same primary objectives: to strengthen the benefit security of plan participants and to reduce the potential liability of the PBGC. Accordingly, we believe that both Proposals should be considered together.

Before the VRP Proposal can be fully evaluated, there are a number of aspects of the Proposal that must be clarified, including the following: Does the VRP Proposal measure the value of a plan's assets on the basis of their fair market value or their actuarial value? Does the Proposal measure a plan's liabilities on the basis of the plan's mortality and early retirement assumptions or the PBGC's? Issues such as these must be resolved before the impact of the VRP Proposal can be adequately assessed.

Furthermore, and wholly apart from the details of the VRP itself, ERIC believes strongly that Congress should not alter the current law under which only Congress may change the payments made by employers to the PBGC. Those payments represent a substantial cost to plan sponsors. Any increase in those payments, which more resemble a tax than they do "premiums," will discourage the maintenance and expansion of private pension plans. Only Congress is in a position to determine periodically whether a change in employer payments to the PBGC is warranted. In no event should the PBGC be allowed to change the payments unilaterally.

Accordingly, ERIC strongly opposes the Administration's proposal for giving the PBGC the unilateral discretion to increase the funding charge periodically. This proposal would give the PBGC the power to impose substantial additional costs on plan sponsors without advance Congressional approval, as is now the case. It would enable the PBGC, on the basis of its own arbitrary interest rate assumptions and its predictions of future claims, to determine how much a plan sponsor will pay to it each year. This would not only represent an excessive delegation of legislative power; it would also empower the PBGC to resolve its own financial problems through "self-help," by unilaterally increasing premiums without Congressional approval.

We also oppose indexing the basic premium (currently \$8.50) and the per participant limitation (proposed to be \$100). There is no reason to believe that the PBGC's liability will increase in proportion to inflation. The \$8.50 premium is designed only to cover the PBGC's existing deficit and its administrative expenses. Indeed, if the Funding and VRP Proposals have their intended effect, the PBGC's liabilities and administrative expenses should actually decline, regardless of what happens to inflation.

The premium rate is too important to the health of the private pension system to be subject to the PBGC's discretion or to automatic indexing. Only Congress should determine whether any change in the premium rate is warranted.

Since the VRP Proposal was released only recently, and legislative language only yesterday, employers have not yet had sufficient time to evaluate its efficacy and impact. However, preliminary indications are that it produces very

surprising results. Many employers whose plans are well funded under current law will find that the VRP Proposal would require them to pay a substantial additional funding charge over and above the basic \$8.50 premium. Preliminary studies by two major employers, neither of which poses any realistic threat to the PBGC's solvency, indicate that under the VRP Proposal their premiums could increase by 300% and 700% in a single year.

Several factors contribute to these surprising results. One factor is the VRP Proposal's use of the PBGC closeout interest rates, rather than the plan's own interest assumption, to measure the plan's unfunded liabilities. Another is the 125% factor that the VRP Proposal uses to inflate the plan's actual unfunded vested benefits. Because of these factors, and perhaps others as well, many employers are surprised to discover that the VRP Proposal would require them to pay a substantial funding charge on plans they consider to be well-funded.

In addition, the number of plans that are subject to a funding charge is likely to increase over time. While the stock market's recent performance has enhanced the value of the assets of most plans, there are inevitably dips in the road ahead. When asset values decline, we may well find that far more plans, involving far more employees and participants, would be subject to a funding charge than are indicated by the Administration's current projections. The Tax Reform Act's accelerated vesting standards, which generally become effective in 1989, will also tend to increase unfunded vested liabilities and thereby subject additional plans to higher funding charges under the VRP Proposal.

We also believe that Congress should seriously consider alternatives to the funding charge called for by the VRP Proposal. Although the Administration has suggested two alternatives -- the purchase of insured annuities and the provision of a security interest to the PBGC -- we doubt that either of these approaches will be a practical alternative for the vast majority of plan sponsors that would otherwise be subject to a funding charge and who in fact pose no threat to the PBGC.

There is simply not enough capacity in the insurance industry to make the purchase of annuity contracts a practical alternative for most plans. Furthermore, the purchase of an annuity contract reflects an investment decision; we question whether it is appropriate for Congress to interfere with the efficient allocation of capital in our economy by encouraging plans to favor fixed-income investments over equities. We are also concerned that, by encouraging employers to purchase insured annuities for their retirees, Congress will unwittingly encourage employers to distance themselves from their retirees and make employers less likely to provide retirees with benefit increases.

Most plan sponsors will not be in a position to give the PBGC a security interest in sufficient assets to avoid a funding charge. Pre-existing security arrangements and loan covenants, and the employer's need to operate its business efficiently and flexibly, make the security interest proposal an impractical alternative. Furthermore, we doubt that the PBGC has the resources to negotiate security arrangements with a significant segment of the employer community. We also question whether it is appropriate, in a democratic, free enterprise society, for an agency of the Federal Government to obtain security interests in a large number of businesses.

We urge Congress to consider seriously a workable VRP that contains both risk and exposure factors. The VRP Proposal relies exclusively on a plan's funded status (i.e., the PBGC's "exposure") to determine whether the plan should be subject to a funding charge and disregards the employer's financial condition. As a result, the VRP Proposal fails to take into account one of the most important factors that determines whether a plan poses a significant risk to the PBGC: the employer's capacity to fund the plan. Because a risk-related premium would take this factor into account, it may well be far more equitable and effective than the Administration's VRP Proposal. For example, a risk-related premium could be based on an objective measure of the employer's credit-worthiness. We are prepared to work with the Subcommittee and its staff on a risk-related premium that would take both risk and funding level into account and, like the VRP Proposal, encourage better plan funding.

Another alternative that Congress might consider is a bond that an employer might post to protect the PBGC against the termination of the employer's plans.

We are also concerned that the VRP Proposal frequently would put an employer in a "Catch 22" situation. For example, an employer that establishes a new plan with vested benefits, provides a benefit increase to retirees, or increases the past service benefits of active employees could be subjected immediately to an additional funding charge under the VRP Proposal. Moreover, the employer might not be permitted to make deductible contributions that would be sufficient to avoid a funding charge and would be subject to a 10% penalty tax if it made a nondeductible contribution. Employers should not pay funding charges to the PBGC for benefit promises that are not yet guaranteed by the PBGC.

The Administration's Funding Proposal would not solve the "Catch 22" problem, since it provides for a deduction only to the extent that the contribution does not cause either the plan's assets to exceed 100% of the plan's termination liability or the assets in all plans of the controlled group to exceed the total termination liability of the controlled group's plans. This is another instance in which the Funding Proposal and the VRP Proposal would require coordination in order to produce a coherent regulatory scheme.

An employer should not be subject to a funding charge until it has had an adequate opportunity to fund any new benefits it establishes. If Congress does not provide this opportunity, a VRP would act as a powerful disincentive against the expansion and improvement of the private pension system. The five-year phase-in of the PBGC's guaranty must also be coordinated with any new premium structure. We suggest that Congress consider lengthening the phase-in period and allowing the employer to use the lengthened phase-in period to fund the plan's benefits sufficiently to avoid an additional funding charge.

We also think that the funding target of 125% of vested benefits is excessive and that it is unnecessary to establish a target exceeding 100% of vested benefits. Indeed, it would be punitive to impose a funding charge on an employer that has fully satisfied ERISA's funding standards and has funded 100% of the plan's vested benefits. Moreover, it would be draconian to impose the charge in 1988, as the Administration proposes, before giving the employer an adequate opportunity to fund for an entirely new 125% funding objective. In any event, a VRP should exempt from the additional funding charge any employer that makes the maximum tax-deductible

contribution to a plan in each year after the VRP becomes effective.

We also are concerned about the arbitrary way in which the PBGC establishes its interest rate assumptions. We recommend that the rates be based on an objective standard, such as specified rates published by the Federal Reserve, to assure that the PBGC's rates are appropriate and that they are fairly and objectively established.

In addition, if Congress concludes that it is necessary to enact legislation to improve the PBGC's financial condition, Congress should consider a wide range of approaches, and should not limit the range of options to more rigorous funding standards and a VRP. For example, we believe that Congress should consider limiting the circumstances under which a plan may qualify for a distress termination. To illustrate, Congress might require that only an employer that liquidates its business under chapter 7 of the Bankruptcy Code will qualify for a distress termination and that reorganization under chapter 11 of the Bankruptcy Code would not suffice. Congress might also consider whether it is possible to improve the PBGC's status as a creditor in the event of bankruptcy. Although ERIC takes no position on whether this would be an appropriate measure, ERIC believes that Congress should investigate this option.

Among the other measures that Congress should consider are an extension of the phase-in period for the PBGC's guarantee, a reduction or elimination of the PBGC guarantee with respect to certain ancillary types of benefits (for example, enhanced early retirement supplements), a requirement that the PBGC maximize its investment return (so that the PBGC will not continue to invest such a high percentage of its funds in fixed-income assets), and measures that would reduce the PBGC's overhead expenses.

THE PROPOSED CONTROLLED GROUP RULE

ERIC opposes the provisions in the Administration's Funding Proposal that would cause any transfer of a plan outside of the employer's controlled group to be treated as a plan termination. This rule would seriously interfere with the purchase and sale of companies in the normal course of business. In addition, the proposed requirement that surplus assets be transferred from well-funded plans to less well-funded plans in connection with such plan terminations ignores the fact that most major employers are in a variety of lines of business, each of which operates as a separate profit center. It would be highly inappropriate to require the pension plan in one line of business to subsidize the pension liabilities incurred by another line of business. This is particularly true where one line of business is a defense contractor, and the federal government has, on a cost-reimbursement basis, financed the contributions that have enabled the defense contractor to maintain a well-funded plan. Similar issues would arise if one line of business were a utility or other regulated industry or if one or more of the plans required employee contributions.

To the extent that the Administration is concerned about a plan sponsor that might attempt to terminate an underfunded plan, while continuing to maintain one or more ongoing pension plans with excess assets, we believe that a more limited remedy would suffice. For example, as we mentioned earlier in this testimony, Congress might wish to re-examine the requirements for a distress termination in a bankruptcy situation.

The Administration seems to be concerned that an employer would attempt to evade its funding obligations by selling a business with an underfunded plan to a buyer that is not financially capable of maintaining the plan. We would point out that only last year Congress addressed and resolved this issue. SEPPA added Section 4069 to ERISA to deal with transactions that are designed to evade liability under the termination insurance program. Congress should not second-guess a judgment it made only a year ago. Before any additional legislation is enacted, Congress should give this provision a chance to work. We believe that experience and analysis will establish that Section 4069 adequately addresses the problems raised by plan transfers.

PLAN ASSET WITHDRAWALS AND TRANSFERS OF ASSETS TO RETIREE HEALTH PLANS

ERIC applauds the recognition in the Administration's Funding Proposal that an employer should be able to withdraw excess assets from a plan without terminating the plan. However, we are unable to support legislation that would make it more difficult for a plan sponsor to have access to such assets than it is under current law. The concepts in the Funding Proposal that would permit plan sponsors to withdraw excess assets and transfer the assets to retiree health plans are strongly supported by our membership. The Funding Proposal's methodology for accomplishing the withdrawals and transfers, however, appears to be so restrictive that few, if any, of ERIC's members would be better off under the Funding Proposal than they are under current law. The controlled group and termination liability concepts set forth in the Funding Proposal represent another example of the proverbial "Catch 22" in that they seem to deprive employers of the ability to do that which the Proposal suggests is its objective.

In addition, ERIC has reservations about the proposal to limit such transfers to health benefit funds for current retirees. There is no compelling justification for limiting the welfare benefit fund proposal to current retirees. If an employer plans to provide post-employment benefits to active employees when they retire, it should be permissible to transfer excess pension assets to fund these future benefits.

Although ERIC supports the concept of a tax-free transfer of excess pension assets to a welfare benefit fund, it will not support this approach if it is accompanied by an unreasonable price tag. If a tax-free transfer provision can be adopted only if objectionable measures proposed by the Administration are also enacted, many employers will strongly oppose the entire package.

Moreover, ERIC strongly opposes the Administration's proposal to eliminate section 401(h), which provides the only tax-favored mechanism for pre-funding retiree health benefits. The Administration's transfer proposal does not permit pre-funding of these benefits. Members of Congress, other policymakers, and workers are becoming increasingly concerned about the growing problem of post-employment health care. It would be wrong to eliminate the only mechanism now available to secure some measure of health coverage for workers who look forward to retirement.

EXPANSION OF TERMINATION LIABILITY DEFINITION

ERIC strongly opposes the broad definition of "termination liability" contained in the Administration's Funding Proposal. Under that definition, a plan's

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"termination liability" would include all of a plan's fixed and contingent accrued benefits, including even benefits that have not vested and benefits for which an employee has not qualified at the time of plan termination.

The Administration is asking Congress to revisit an issue that Congress addressed and resolved last year. In SEPPA, Congress determined that a plan would satisfy all of its obligations if it had assets sufficient to meet its benefit commitments at the time of termination. A plan's benefit commitments include all guaranteed benefits, all other vested benefits that would be guaranteed if it were not for specific limitations imposed by ERISA, and all early retirement supplements or subsidies or plant closing benefits that the participant has qualified for prior to plan termination. We believe that any expansion of this definition would unjustifiably expand the plan's pension obligations.

The Administration's definition of "termination liability" would go far beyond what is necessary to protect the PBGC and far beyond what a plan may promise to its participants. For example, if a plan offered special plant closing benefits, the Administration's Funding Proposal appears to prevent the sponsoring employer from terminating the plan in a standard termination unless the plan has assets sufficient to provide the plant closing benefits in the event that a plant closing occurs in the future -- after the plan termination.

The Funding Proposal thus would expand the scope of the plan's commitment to events that occur after the plan terminates. This would extend the employer's pension promise beyond the provisions of the plan, beyond what labor and management have agreed to in a bargained plan, and beyond the termination of the plan. Such an interference with the design of private pension plans is inappropriate and inconsistent with the decision that Congress made just last year when it limited a plan's obligation to its benefit commitments.

It bears emphasis that the private pension system is a voluntary system. Employers are not required to maintain a pension plan. If Congress now enacts legislation that makes it difficult or impossible for an employer to terminate a plan -- if adopting a plan becomes an open-ended commitment that an employer cannot terminate -- employers will be strongly discouraged from adopting pension plans and from adding additional benefits to their existing plans. Since the Administration's "termination liability" concept would have precisely this effect, we believe that the Administration's concept of "termination liability" would severely damage the private pension system as we know it today. We oppose this concept.

We very much appreciate the opportunity to present our views to the Subcommittee. As in the past, we will be pleased to continue to work constructively with the Subcommittee and its staff on these issues.

Thank you for your consideration of our views.

Chairman PICKLE. We thank you, Mr. Labedz, and we appreciate your concise statement.

The next gentleman will be Mr. Richard Fay, representing the U.S. Chamber of Commerce.

STATEMENT OF RICHARD H. FAY, CHAIRMAN, EMPLOYEE BENEFITS COUNCIL, U.S. CHAMBER OF COMMERCE

Mr. FAY. My name is Richard Fay, and I am here because I am the chairman of the Employee Benefits Council of the United States Chamber of Commerce.

With me is James Klein, who is the manager of employee benefit and pension matters for the chamber.

I would like at this time to give you the chamber's initial reactions to the administration's proposals dealing generally with the termination and funding of defined benefit pension plans, recognizing fully that with proposals of such scope and complexity, that it is impossible to analyze them accurately until they are incorporated in a proposed piece of legislation.

The chamber supports the administration's proposal for greater and faster funding. We believe this to be the right approach to solving PBGC's problems created by poorly funded plans. But this should not allow us to forget the fundamental fact that pension plans were never intended to be, nor should they be, fully funded at all times.

We oppose the increase of employers' liability upon the termination of a plan from benefit commitment, a legal obligation just a year old today, to termination liability—yet another new and undefined term.

The usual justification for these kinds of changes is that employers are merely being asked to pay for what they have promised. Nothing can be further from the truth. By law, the legal consequences of many pension provisions have been altered. Nonvested benefits have become vested. Early retirement benefits and subsidies have been turned into protected accrued benefits, and contingent liabilities have become fixed benefits.

Also, the chamber is very concerned about the proposal by the administration that most of their suggested changes be applied not on the basis of a single plan, as is current law, but on a controlled group basis. This approach will require the most extensive and complex provisions dealing with changes in the composition of controlled groups, and is totally unnecessary and would be a drastic interference with necessary business decisions.

The chamber believes that an employer upon terminating a defined benefit plan and paying all benefits under that plan, that any excess assets should be returned to the employer. This is a right that was recognized in ERISA. This is a right that has been upheld by every court who has reviewed this issue.

We therefore are disappointed in the administration proposal because we view it as a substantial diminution of this right. And in fact, for good-sized companies, part of a controlled group maintaining more than one plan, the right is practically eliminated. Its elimination is caused by the application of the interrelated provisions of the administration proposals as follows:

One, as has already been stated, they increase the employer's liability to termination liability. Then, they create another new term called "minimum benefit security level" resulting in many comfortably funded plans will now fail to meet that standard.

Third, they say that if an employer terminates the plan, that the reversion cannot be greater than the amount the employer could have withdrawn from the plan.

Fourth, and much more significantly, is the rule that is called the frequency rule, but I think more aptly described as the "once in 10 years rule." Under this rule, one member of the controlled group can do only once in a 10-year period the following acts. A reversion, a withdrawal, a transfer of excess assets with the plan sponsorship beyond the controlled group, transfer of excess assets to health retirement benefit for retirees, transfer of 401(h) plans to these retiree plans—it is absolutely absurd to maintain that the right of reversion has not been almost eliminated.

We support the administration's proposal that employers be allowed to make withdrawals from ongoing plans, and we believe this proposal has merit. But we would not support it, nor do we believe it should be used as a justification for a diminution of any existing employer rights, particularly the right to reversion.

We also support the administration's proposal that excess assets be transferred to a retiree health plan, but in all candor, when weighed or judged against the magnitude of the problem, this proposal is irrelevant.

Also, by having the frequency rule triggered by such a transfer, it almost guarantees that nobody would ever use it.

The administration's proposals raise very fundamental questions about the exclusive benefit and prohibited transaction rules of ERISA, and these issues must be addressed in any legislation or its legislative history.

Finally, the administration proposes that many of the substantive provisions be effective retroactively, and the chamber opposes retroactive effective dates.

Thank you very much.

[The prepared statement follows:]

STATEMENT
on
PENSION PLAN FUNDING
before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS & MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Richard H. Fay
April 7, 1987

Mr. Chairman and members of the Subcommittee, I am Richard H. Fay, partner in the law firm Reed Smith Shaw & McClay. I serve as Chairman of the U.S. Chamber of Commerce's Employee Benefits Council. I am pleased to appear at today's hearing on behalf of the Chamber. Accompanying me is James A. Klein, Manager, Pension and Employee Benefits for the Chamber.

THE IMPORTANCE OF WELL-FUNDED PENSION PLANS

Responsible funding of pension plans is a practice that benefits everyone. Clearly, the retirement income security of employees and retirees is served best by private pension plans that are well-funded. The interests of employers, too, are met by well-funded pension plans. A well-funded plan helps a particular company to assure its employees that the pension promises made to them will be fulfilled. In addition, businesses in general--the vast majority of which responsibly fund their pension plans--have a significant interest in policies that require all sponsors of defined benefit plans to fund their plans adequately. After all, it is employers that bear the burden of financial support of the Pension Benefit Guaranty Corporation's (PBGC) termination insurance system; and the employers that remain within that system prefer not to pay for the retirement benefits of other firms' employees.

Ultimately, it is the American public whose interests are served by well-funded private pension plans. Not only is a better quality of life and economic prosperity fostered by a financially secure elderly population, but also the American taxpayer is better off when the private pension system is

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financially able to provide these retirement benefits. The taxpayers will be the ones who, in the final analysis, may be called upon to support a financially troubled pension termination insurance system or to provide retirement income security through greater Social Security expenditures, if private pension plans are funded inadequately.

It is with these interests in mind that the Chamber always has supported responsible pension plan funding--including a number of the reforms to the pension termination insurance system contained in the Single Employer Pension Plan Amendments Act signed into law last year. Therefore, we are especially pleased to share with you our impressions of the Reagan Administration's pension plan funding proposals. A memorandum, which I have prepared, that analyzes the Administration's proposals also will be submitted as part of the formal hearing record.

The Chamber's perspective on plan funding and the Administration's proposals essentially can be articulated in seven points, the background of which is further developed later in the statement.

First, the Chamber believes that the reversion privilege, as it now stands, should not be lost to employers.

Second, the Chamber contends that withdrawals of excess assets in overfunded plans should be permitted with a "cushion" of excess assets over current benefit commitments. Other burdensome restrictions that have been proposed make the withdrawal option unattractive to employers.

Third, the Chamber is concerned that the cumulative effect of the proposals will be the termination of pension plans and the discouragement of the establishment of new plans.

Fourth, the Chamber contends that excess assets should be allowed to be transferred, on a tax-free basis, at the employer's option, to fund health care benefits for current and future retirees.

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Fifth, the Chamber favors modification of minimum funding rules to improve the funded status of plans that are currently underfunded on a benefit commitment basis, effective on the date of termination or asset withdrawal.

Sixth, the Chamber could support a policy of no continued benefit accruals or benefit increases during a time that a plan dangerously is underfunded.

Seventh, while the Chamber commends the Administration's goal of improved funding and termination conditions, we have reservations about the effects of the actual proposals. The Chamber is troubled by the emphasis on the "employer/controlled group," which permeates the proposals. We believe that is unnecessary for the protection of plan participants and unduly complicates the entire funding, termination, and business management process.

OVERFUNDED PENSION PLANS

The Chamber believes that the enormous attention paid to the issue of reversions from overfunded pension plans is grossly misdirected. It is underfunded plans that really should be the focus of attention for Congress and the Administration.

The debate over the disposition of excess funds has turned on the question of "whose money is it?" However, the real issue is and ought to be whether plan participants are receiving the pension benefits promised to them. Very definitely, employers exercising reversions are fulfilling their obligations since they must ensure payment of promised benefits to all plan participants before they may take back a single penny. The reversion, after all, is only of the excess assets. In addition--and this is a point that opponents of reversions tend to ignore--even plan participants who are not vested in a pension benefit of an ongoing plan immediately become vested in the value of their accrued benefit upon a plan termination/reversion.

With respect to the question of whose money is the excess assets--the Chamber firmly believes that it belongs to the employer-sponsor of the plan. The promise that sponsors of defined benefit pension plans make to employees is a promise of certain pension benefits, calculated by a formula. As long as this promise is kept, the excess funds should be available to the employer.

Before Congress undertakes to draft legislation or to respond in detail to the Administration's proposals dealing with overfunded plans, we strongly encourage it to review the history of national pension policy with respect to overfunded plans. The testimony submitted by Peter M. Kelly on behalf of the Chamber to the U.S. Department of Labor ERISA Advisory Council's Termination Task Force is attached (See Appendix). That testimony explains in great detail the deliberate policy enunciated by Congress nearly 50 years ago in establishing a process that permits reversions. The essence of that policy was and is a congressional recognition of the fact that permitting reversions is important in encouraging companies to fund their pension plans responsibly. It also acknowledges that companies that bear the risk of underfunded plans also should have access to excess funds in responsibly funded plans, once all promised benefits are paid to participants.

To restrict reversions unduly is to deny to employers the quid pro quo for the liability they bear to finance their underfunded plans adequately. Ironically, restrictions on reversions actually penalize those employers who have kept their pension promise by responsibly funding their plans.

THE NUMBER OF PENSION REVERSIONS IS DECREASING

Apart from the philosophical and legal bases for not restricting reversions, which are enumerated above and in the Appendix, a very practical reason exists for moving attention away from this issue--there simply are very few companies engaging in a termination/reversion and the pace is slowing.

Of the literally hundreds of thousands of defined benefit pension plans in existence in the years 1960 through 1966, only 1,336 pension plans had terminated with reversions in excess of \$1 million.

While the amount of reverted assets in that seven-year period approaches \$16 billion, let us put it in perspective: our nation's private pension system has assets of nearly \$2 trillion--50 percent of our gross national product. The amount of pension assets reverted over the past several years is a very small percentage of the total money in the pension system.

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Moreover, the claims of benefit loss following pension reversions are greatly exaggerated. The PBGC has reported that following terminations/reversions, 70% to 80% of plan participants continue to be covered by identical or superior defined benefit plans. About 5% to 8% of plan participants were left with no successor plan and, in most of these instances, the plan was terminated because the plan sponsor had gone out of business.

Consider this: while total assets reverted since 1960 approximate \$16 billion, the total unfunded liability of underfunded plans right now exceeds \$45 billion. Is not the attention focused on the wrong issue?

The evidence that the pace of terminations/reversions is slowing down is clear. In 1965, the PBGC reported 525 reversions. In 1986, that number dropped to 194. The chief reasons attributable for this decline are 1) lower interest rates, which have reduced the level of overfundedness of many plans and 2) the 10% excise tax on reversions imposed by the Tax Reform Act of 1986 (P.L. 99-514). Although interest rates may rise again in the future, the excise tax remains and it undoubtedly chills the interest of some companies to take a reversion.

THE ADMINISTRATION'S PROPOSALS ON REVERSIONS AND WITHDRAWALS

The Administration has proposed a number of policy changes with regard to terminations/reversions and has suggested a mechanism for withdrawals from ongoing plans. We wish to address the specifics of these proposals.

The Administration's proposal to allow withdrawals of excess assets is an attempt to balance certain interests: giving employers access to money not needed to pay promised benefits, while avoiding the necessity of an actual plan termination. Some employers may welcome this alternative to obtaining pension assets.

The Chamber believes that a workable withdrawal policy that allows an adequate safety cushion to protect plan participants' interests and is simple enough to enable employers to use it, would be a positive step. It would enable employers to have access to their funds without requiring the

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termination of the plan. A cushion of 20% over benefit commitments (a figure suggested by the Department of Labor ERISA Advisory Council's Termination Task Force) seems to us to be an appropriate level. The withdrawal option, however, should not be in lieu of but rather in addition to a continued right of termination/reversion.

Most of the comments that the Chamber has heard from its members have noted that the restrictions on reversions are unnecessary and the withdrawal option, because of all of its costly requirements and undue restrictions, is not really an attractive alternative.

The Administration's focus on the "controlled group" for purposes of determining both the frequency of withdrawals or terminations/reversions, and the amount of assets that may be recovered through a reversion or withdrawal is overly broad. Many companies terminate plans regularly in the normal course of events--not in order to recover excess assets or to shift liability for an underfunded plan to the PBGC. Mergers, acquisitions, sales of subsidiaries, combining plans for ease of administration or to equalize benefits offered to a company's employees are all normal business reasons for a pension plan to terminate. Application of the "controlled group" test for purposes of determining the level of recovery of assets by means of either withdrawal or reversion is overly-cumbersome and does not account for these normal business transactions.

In addition, the Administration proposal to prohibit an employer from reestablishing a defined benefit plan -- for the same employees for five years following a termination/reversion -- can only be viewed as an attempt to discourage terminations/reversions. A study prepared for the U.S. Department of Labor ERISA Advisory Council's Termination Task Force by the Hay/Huggins Company, Inc., in April 1986 showed that among the terminations/reversions studied, the establishment of defined benefit successor plans, either as a result of a "spinoff/termination" or a "termination/reestablishment," was the practice in over 75% of the cases. This common practice is beneficial to plan participants and no valid purpose is served by restricting it and creating a disincentive to the establishment of defined benefit plans.

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Other elements of the proposal also provide disincentives for establishment of new plans. For example, the proposed prohibition of terminations/reversions during the first 10 years of a plan's life will serve only to preclude the establishment of such plans. Again, we note that the basis for congressional support for reversions for the past several decades has been to encourage companies to establish and responsibly to fund them. A common criticism of the current reversion policy is that it fosters plan terminations. We believe that the evidence of the infrequency of terminations/reversions suggests otherwise. However, the Chamber has a genuine concern that the complexities of the proposed reversion/withdrawal mechanisms could encourage employers to abandon the defined benefit plan system altogether or to decide not to enter it. If there is to be a place for defined benefit plans in a vibrant private pension system, incentives--not obstacles--to their creation must be fostered.

RETIREE HEALTH BENEFITS

One positive element of the Administration's proposal is the recommendation to permit the transfer of excess plan assets available for withdrawal to a tax-favored health fund for current retirees.

We should be clear regarding what this proposal is and what it is not. It is not a mechanism to allow employers greater flexibility to pre-fund health benefits for future retirees. That ability was restricted in the Deficit Reduction Act of 1984 and regrettably but understandably unfunded retiree health liabilities have increased. This is a problem that employers and employees alike would like to address in a responsible fashion. The current Administration proposal on retiree health benefits is a modest and positive initiative, which will help to address a portion of the problem of unfunded health benefits for current retirees.

It should be noted that under the proposal the transfer of excess pension assets to a health fund is treated as a withdrawal from an overfunded plan. Thus, unless the withdrawal provisions are made more attractive, very few employers will avail themselves of the transfer mechanism.

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There can be no denying that the unfunded retiree health liabilities are real and enormous. Prohibitions or undue restrictions on funding for these liabilities is short-sighted and will result in shifting future health care costs to participants or taxpayers. It would be better for all parties concerned--employers, beneficiaries, and taxpayers--to encourage adequate funding of these obligations by employers.

It is with this thought in mind that we recommend that employers be permitted to have access to excess pension assets on a tax-free basis if the assets are dedicated to retiree health benefits for current or future retirees.

UNDERFUNDED PENSION PLANS

By far the more important issue in pension funding policy is how to improve the status of underfunded plans. This is an issue fraught with controversy, yet vitally important to both the retirement income security of many Americans and to the financial health of several companies. Chamber members are convinced that workable and prudent funding rules are the key to well-funded plans. We support modification of minimum funding rules to improve the funding status of plans that currently are underfunded on a benefit commitment basis effective on the date of termination or asset withdrawal. However, we would oppose other alternatives that are disruptive or overly-burdensome.

In recent years, a number of voices outside the business community have drawn attention away from the problems posed by underfunded plans by focusing attention on terminations/reversions from overfunded plans or by insisting that changes in our international trade policies might solve the problem of underfunded plans.

Fundamentally, we believe that improved funding really can be achieved only by following two steps. First, we must address squarely the deficiencies of pension and tax policy that contribute to underfunding. Second, we must undertake deliberately and cautiously the changes necessary to improve the funding status of pension plans that are underfunded with the least disruption to businesses, plan participants, and the pension termination insurance system.

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In order to put the issue of underfundedness in proper perspective, we should start with the recognition that the private pension system is generally in good shape. At the end of 1986, the unfunded liabilities in underfunded plans were approximately \$45 billion, according to the U.S. Department of Labor. The excess assets in overfunded plans at the same time were about \$263 billion, leaving a net excess of \$218 billion in defined benefit plans. As indicated earlier in this testimony, terminations/reversions for the entire period 1980 through 1986 amounted to only about \$16 billion. Therefore, one may conclude that the vast majority of plans are both well-funded and continuous. Nonetheless, the \$45 billion figure--and the potential financial risk it poses to participants and the termination insurance system--must be considered seriously.

There is some conflicting data as to whether funding has improved or worsened in recent years. Various surveys indicate improved levels of pension funding measured on a termination basis. For example, Greenwich Associates' data regarding 1,500 of the largest corporate single-employer plans show that the rate of pension assets to accrued liability rose from a 70% ratio in 1978 to a 95% ratio in 1985. Likewise, data compiled by the Wyatt Company concerning plans with 1,000 or more participants show that the percentage of plans fully-funded for accrued vested benefits and total accrued benefits has risen steadily from 1979 through 1985. Though the plans surveyed are not necessarily a representative sample of all defined benefit plans in the country, they do include the large-sized plans that are most likely to pose a risk of greater liability to the PBGC if they are terminated or become underfunded.

A different picture was painted by a recent report issued by the United States General Accounting Office (Pensions: Plans With Unfunded Benefits, October 1986), which concluded that the contingent liability to the PBGC insurance program is significant and growing.

Though the studies mentioned above did not necessarily include the same plans, or cover the same periods, they are helpful when viewed in the aggregate. They confirm that most plans are well-funded but that a number are not--and that those plans that are not do pose a growing financial threat to the PBGC. Further analysis of underfunded plans would demonstrate that plans

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that are underfunded are generally pension plans that provide a "flat dollar benefit"--such as \$10 multiplied by the participant's years of service for the employer. This type of plan has been for years the prototype plan for hourly paid workers in the industrialized sector of America--regardless of whether the employees are union or nonunion. As discussed below, current federal policy not only discourages adequate funding of this type of plan but also often prevents plans from being funded adequately. Other types of plans besides flat dollar benefit plans also may be underfunded, and the reasons for those underfunded situations also are discussed below.

THE CAUSES OF UNDERFUNDING

Before one can begin to determine the appropriate responses to the underfunding problem, it is critical to recognize the many factors contributing to this condition.

The first factor often is that an employer is permitted to adopt a plan that provides benefits for employees' prior service, but Section 404 of the Internal Revenue Code does not allow a tax deduction for the adequate funding of such benefits. Typically, when an employer adopts a flat dollar benefit plan, the plan provides benefits for the employees' prior service. This is logical because the plan generally is being adopted to meet the needs of the long-term employees. What is not logical is that even if the adopting employer wants to fund for this past service liability, it is unable to do so and take a deduction for such funding. We note that the Administration's proposal on deductions would cure this defect, and we support this aspect of the proposal.

The second factor is that benefits payable for a flat dollar plan are not based upon the compensation of employees, and the only way for the benefits to increase to reflect inflation or the higher pay levels of the participants is by plan amendment. Typically, plan amendments increasing benefits have been adopted every few years. During the highly-inflationary period of the 1970's, it was not unusual for the benefits under this type of plan to double or triple in a relatively short period.

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Under the funding rules, benefit increases must be amortized over a period of 10 to 30 years, even though they will be insured fully by the PBGC in five or fewer years. With pension benefit increases occurring every few years and funding at a rate faster than 10 years effectively prohibited, the flat dollar pension plan never can reach full-funding status.

A third factor is pension plan provisions that trigger benefits upon the occurrence of certain events (e.g., the closing of a facility, the cessation of the employer's business, or the termination of a certain collective bargaining unit). Such provisions frequently are contained in flat dollar benefit plans that typically cover the employees of a certain collective bargaining unit or facility. Since the lifespan of such a pension plan is unpredictable and the plan may cease to exist suddenly, the benefits that are triggered pursuant to the plan's provisions may not be funded when the plan terminates.

A fourth factor is the number of waivers to the minimum funding standards that are granted by the Internal Revenue Service. Funding waivers are by no means necessarily negative. It is important to remember that companies seeking such waivers are often those that might otherwise have to reduce severely or cease operations if the waivers are not granted. Clearly, in such a situation, massive layoffs or cessation of business operations pose a more serious danger to the well-being of the company's employees and to the pension termination insurance system than the granting of a funding waiver. Nonetheless, numerous waivers can diminish a plan's funding status with potentially greater adverse consequences when the plan ultimately terminates.

The Chamber is pleased that among the reforms to the single employer pension termination insurance system that were enacted as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) is a requirement that the PBGC (which bears the risk of underfunded plans) be notified when the IRS receives a funding waiver application. Moreover, under COBRA, the IRS is permitted to require "security" as a condition of granting funding waivers.

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Related to the issue of funding waivers is the fact that benefits continue to accrue and benefit increases are sometimes granted during periods when funding waivers are in effect. This can be problematic. If the employer cannot afford to make contributions for benefits that have been accrued under the plan, it may not be in a financial condition to incur even greater unfunded pension liabilities. Freezing accruals and halting benefit increases at a time when a funding waiver is permitted might lessen the impact of mounting liabilities at a time when the ability to fund a plan is tenuous.

A fifth factor is federal legislation that mandates benefit increases. The provisions of the Retirement Equity Act that require joint and survivor benefit options in all plans diminish the funding status of plans. Likewise, the provision of the Tax Reform Act that requires five-year vesting will diminish their funding status. Similarly, the new so-called nondiscrimination rules contained in the Tax Reform Act, by forcing coverage of additional groups of employees, will have a negative impact upon funding levels. The Chamber absolutely believes that pension plans should not discriminate, that the vast majority of plans do not, and that these proposals to change the nondiscrimination rules were unnecessary and precipitous.

THE ROLE OF FUNDING STANDARDS

The minimum funding standards of ERISA were intended to ensure that pension plans do not become dangerously underfunded. Certainly, for the most part, they have been successful. However, in the case of the flat dollar benefit plan, the funding standards actually inadvertently encourage underfunding. For example, the period for funding past service accrued benefits is 30 years, while the same benefits become insured by the PBGC in five years. The 30-year funding rule certainly was appropriate for benefits that were accrued prior to the adoption of ERISA. Employers needed that length of time as an incentive to maintain plans and to provide benefits for prior years of service. Likewise, since the enactment of ERISA, plans have been adopted or benefits have been increased on the assumption that these benefits will be funded over a 30-year period.

The Administration now is proposing a faster schedule of funding for underfunded plans. The Chamber favors modification of minimum funding rules to improve the funded status of plans that are currently underfunded on a benefit commitment basis, effective on the date of termination or asset withdrawal. This is fundamental to improving the financial stability of plans and protecting the retirement income security of plan participants.

Critical to requiring more rapid funding is ensuring that the funding is not so precipitous that it creates undue financial burdens on the companies involved. At the very least, rational and workable transition rules are needed for companies that have complied with current law in making their funding decisions. We have seen, time after time, that legislative changes that are too costly to implement and inconsistent with corporate expectations have a negative effect on the willingness of employers to continue or to establish pension plans.

We already have commented on the careful approach that the Chamber believes must be taken with respect to funding standards. An additional point should be noted. As in the discussion on overfunded plans, we maintain that the liability of the controlled group members, for application of the minimum funding rules to each ongoing defined benefit plan, is overly-broad. It does not account for the myriad reasons that different plans of the same employer/controlled group may have different funding status.

Other components of the Administration's proposal also deserve discussion. Some tightening of the frequency of minimum funding waivers may be in order. However, the Administration's plan to permit waivers only during "temporary hardship" is not clear. The ultimate definition of temporary hardship would dictate whether qualifying for that status is so difficult to achieve that the purpose of granting a waiver is undermined.

The Chamber supports the proposal liberalizing the deduction for a contribution in excess of otherwise applicable contribution limits. Within the parameters of expanded deductions that are financially prudent, given federal budget deficit considerations, the encouragement of additional funding would aid the cause of fuller funding.

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The proposed changes in employer liability in the event of termination require scrutiny. The Administration is proposing that insufficiently-funded plans could not terminate, unless the employer and controlled group satisfy the criteria for a "distress" termination. The Chamber is proud of the positive role that it played in encouraging some of the reforms of the Single Employer Pension Plan Amendments Act. While we certainly are not pleased with all of the enacted changes, the development of the concept of a distress termination is an improvement over prior law. Not only does the Administration proposal require the applicability of the distress test on an employer/controlled group basis, but also the liability itself in a distress situation would be increased from the current law percentage of benefit commitment test to the full amount of a plan's unfunded termination liability. These new requirements simply seem too draconian in the absence of any evidence that the distress classifications--enacted only last year--are not workable.

Again, we repeat, the focus on the controlled group, for purposes of requiring inter-plan transfers of assets in the event of a termination is an unwise encumbrance on the pension system and discourages plan establishment. Worst of all, it is subject to misuse by employers and employee groups. For example, a group of employees covered by a particular plan offered by the employer/controlled group might negotiate for higher benefits--even if the benefits cannot be funded adequately--since other well-funded plans of that employer/controlled group will have to bear the risk for the underfunded plan. Ironically and unfairly, the employees who choose to forego higher benefit promises in exchange for more secure but lower levels of benefits, actually will subsidize more generous benefits for other workers who are less concerned with adequate funding. To some degree, this kind of cross-subsidization already exists within the framework of the current termination insurance system. It should not be fostered within an employer/controlled group.

CONCLUSION

The above matters are but a few of the myriad issues that arise in considering changes to the laws governing pension plan funding. The issues are fraught with complexity, and the implications for retirees, companies and taxpayers are great. We pledge to work closely with the Subcommittees to analyze the Administration's proposals and we appreciate the opportunity to present our views to you.

APPENDIX

TESTIMONY

on

PENSION REVERSIONS

before the

TERMINATION TASK FORCE

of the

ADVISORY COUNCIL

on

EMPLOYEE-WELFARE AND PENSION BENEFIT PLANS

of the

DEPARTMENT OF LABOR

on behalf of the

CHAMBER OF COMMERCE OF THE UNITED STATES

by

Peter M. Kelly

January 13, 1986

My name is Peter M. Kelly. I am a partner in the law firm of Bell, Boyd & Lloyd. I am based in that firm's main office in Chicago, Illinois, and head the firm's employee benefits group. I also chair the Reversion Task Force of the Employee Benefits Council of The United States Chamber of Commerce. I appear before you on behalf of The Chamber of Commerce of the United States to express the Chamber's views on the subject of the reversion to employer sponsors of assets remaining in terminated defined benefit pension plans following full satisfaction of promised benefits. I am accompanied by James Klein, the Chamber's Manager of Pension and Employee Benefits.

For the reasons set forth in detail below, the Chamber is concerned about repeated efforts to overturn the time-tested principle that employers who prudently fund their defined benefit pension plans and keep their pension promises should be allowed to recover any assets remaining after a plan termination. This principle has been a key element of our national pension policy

for at least 48 years and has provided an environment which is conducive to employer voluntary creation of pension entitlements.

By prudently funding its plan, an employer entitled to a reversion has successfully avoided the dangers to itself, its shareholders, its employees and to the termination insurance system which are implicit in the maintenance of an underfunded plan. In addition, by complete funding of benefit entitlements such an employer has fulfilled its pension promises. As such plans reach the end of their life cycles, the employers maintaining those plans only seek what is their due when they recover excess asset reversions. The reversions which they receive and include in taxable income represent the flip side of the risk they previously took. They were obligated to make up any shortfalls during the life of the plan. Now they only seek a return of what is theirs.

I. Current Rules

We suggest that your study should begin with a restatement of the existing rules and the national policy implicit in the current status quo.

A. Defined Benefit/Defined Contribution Distinction.

In the debate over pension plan terminations a fundamental point is sometimes obscured. There is a significant difference between pension plans of the defined benefit variety and other forms of employee retirement plans (defined contribution plans). Under each type of plan the rewards of better than expected investment performance goes to the party that bears the risk of investment losses.

Employer contributions to a defined benefit plan are in effect a down payment on each participant's fixed or determinable retirement benefit. In an ongoing plan, participants are entitled to receive the benefit provided in the plan even if due to investment losses or other adverse actuarial experience the cost of that benefit is greater than the participant's proportionate share of plan assets. Any such shortfall, if not offset by subsequent favorable experience, must be made up through future increases in the employer's contributions. Thus, employees know they will receive no more nor less than the plan formula benefit and are relieved of the risks of investment or other plan losses. These risks fall upon the employer who is obligated to make the required pension contributions which together with investment earnings will be sufficient to meet the pension promises contained in the plan. If plan assets are insufficient such employers must contribute additional funds from current earnings or other company assets to fund that insufficiency.

An employer's contributions to a defined contribution plan (e.g., a profit sharing or money purchase pension plan) are irrevocable. The benefits of plan investment earnings and the risk of plan investment losses rest solely upon the employees. Plan participants will receive at retirement whatever level of benefit may be purchased with their account balances. If investment performance is better than expected the employee will receive a greater than otherwise expected retirement income. If earnings are less than expected the employee not the employer bears that risk.

The tradeoff between a defined benefit and defined contribution plan may be expressed as follows: The employee in a defined benefit plan has security regarding the level of benefits to be provided whereas the employee in a defined contribution plan is at risk with regard to the level of benefits. The employee's benefit is backed by the company that sponsors the plan, by the minimum funding standards and the Pension Benefit Guaranty Corporation ("PBGC").

As recent history has clearly revealed, the PBGC guarantee is not complete protection. The primary protection of employee expectations is the promise of the employer to make the required contributions. In return for accepting the risk of providing employees this protection, the employer retains the right to recover any extra assets remaining following full satisfaction of plan liabilities. In an ongoing plan this translates into the potential that future contributions may be reduced if earnings or other plan experiences are better than expected. However, in a terminating plan this is reflected in the right of the employer to recover the excess assets as taxable income.

B. Origin and History of the Current Rules. Most retirement plans are no more than a generation old. The period of explosive growth of qualified retirement plans began in the 1950's and has continued until the present time. Prior to the 1950's Congress gradually developed a series of qualification requirements and other rules which employers have relied upon.

The fundamental rules and policies which gave rise to the explosive growth in plans have not changed in 43 years. They have served us well. These rules have stood the test of time, including the intense scrutiny of two Presidential commissions and the major Congressional restructuring of other aspects of plan operations which was reflected in the Employee Retirement Income Security Act of 1974 ("ERISA").

1. Pre-1950 Period. The provision now incorporated in Section 401(a)(2) of the Internal Revenue Code has its origin in the legislative history of Section 219(f) of the Revenue Act of 1921. That Section for the first time granted tax exempt treatment to a trust established by an employer to provide retirement

benefits. The bill as reported by the Senate Finance Committee required that the trust be irrevocable. Sen. Rep. 275, at 16, 67th Cong., 1st Sess. (1921), Seidman, Seidman's Legislative History of Federal Income Tax Laws, 1938-1861 at 850-51 [hereinafter Seidman].

A Senate floor amendment deleted this requirement. The record of the debate reveals that the Senate was aware that this change permitted revocable trusts to qualify for tax exemption. 61 Cong. Rec. 7113, Seidman at 851.

Section 165(a)(2) of the Revenue Act of 1938 provided express statutory authority for reversion of excess assets remaining in a terminating plan. The language of that Section is virtually identical to the current provision of IRC Section 401(a)(2). This language was added by the Senate Finance Committee to a House Ways and Means Committee provision which would have prevented any use of trust assets for any purpose other than providing benefits to the employees. H. Rep. 1860, at 46-48 and Sen. Rep. 1567, at 24, 75th Cong., 3d Sess. (1938), Seidman at 86-87. The House receded to the Senate position in the conference committee deliberations. H. Rep. 2330, at 45, 75th Cong., 3d Sess. (1938), Seidman at 87.

The 1938 Senate Finance Committee Report contains the following description of the reversion provision:

This section of the House bill relating to the exemption from tax of employees' trusts, is retained in the bill, except with a change which is deemed advisable in fairness to employers. Under the House bill an employees' trust..is not exempt from tax if it is possible at any time for any part of the trust principal or income to be used for, or diverted to, purposes other than the exclusive benefit of employees. However, it is quite possible that after satisfaction of all pension liability under the trust, an additional amount of funds of the trust will remain, due to erroneous actuarial computations during the previous life of the trust. It seems desirable to allow the employer to provide for the return of such an amount in the trust without the trust losing its exempt status in Section 165. Of course, under the provisions of Section 23(p), the amount recovered by the employer must be reported by him as income. Accordingly, Section 165 of the reported bill provides that an employees' trust will be exempt from tax if at any time before the pension liabilities with respect to employees under the trust have been satisfied, it is impossible for any part of the trust fund, including principal and

income, to be used for, or diverted to, purposes other than the exclusive benefit of employees. Sen. Rep. 1567, at 24, 75th Cong., 3d Sess. (1938), Seidman at 87.

Excess asset reversions were again considered in conjunction with the Revenue Act of 1942. Although the prior acts did not expressly require the employees' trust to be irrevocable in order to be tax exempt, the report of the Ways and Means Committee Report included a statement that irrevocability was a requirement for tax exemption under the 1938 Act. H. Rep. 2333, at 50, 77th Cong., 2d Sess. (1942), Seidman at 2099. In addition, the House passed version of that bill would have amended Section 165(a)(2) to remove the employer reversion provision. Id. at 103-105, Seidman at 2100.

The bill passed by the Senate restored the asset reversion provisions. Sen. Rep. 1631, at 136-138, 77th Cong., 2d Sess. (1942), Seidman at 2101-2103. The Senate was upheld in this action by the Conference Committee and subsequent passage of the conference bill. H. Rep. 2586, at 52-53, 77th Cong., 2d Sess. (1942), Seidman at 2101-2103.

2. 1950 to the Present. Since 1950 there has been a dramatic growth in the number of qualified defined benefit pension plans. Throughout this period of plan growth no serious effort was made to restrict the right of employers to recover excess assets.

It can be justifiably concluded that a whole generation of corporate managers have exercised the business judgment that their companies should invest in the future retirement security of their employees on the condition and with the express understanding that excess assets could be recovered in the event of plan termination. This reliance interest must not be taken lightly. Under our laws parties who act in justifiable reliance on settled principles of law in the ordering of their private and commercial affairs are entitled to protection against legislation or regulations arbitrarily and retroactively defeating those reasonable expectations. Any change in existing laws regarding asset reversions is a serious undertaking and should preserve the basic principles of current law.

C. Policy Implicit in the Current Rules. It is frequently stated that there is no national policy on this subject or that subject. The retirement plan area is no exception. However, this rhetorical technique is often a shorthand form of saying that the speaker opposes existing policy or has not made the disciplined effort necessary to discover that existing policy.

There is a national policy regarding reversions. It is implicit in the rules now in effect. Any principled effort to establish new policy or apply existing policies to new situations should begin with a rediscovery of the existing rules and their policy implications.

The current rules permitting reversions have the following retirement policy implications:

- (a) Permitting reversions encourages the establishment of defined benefit pension plans;
- (b) Permitting reversions encourages sound funding; and
- (c) Permitting reversions fairly distributes extra assets to the party bearing the risks of funding.

1. Plan Formation. It is no accident that there has been an increased incidence of reversion activity over the past two to three years. This increased termination activity corresponds with the time period during which we have heard serious proposals to undermine the ability of employers to recover reversions in the event of plan terminations.

Employers perceive many of these proposals as no more nor less than an asset grab. It should be no surprise that employers who have prudently funded their plans are beginning to feel quite beleaguered by these proposals. Employers are also sensitive to the irony that these proposals have come at a time when the case law has reinforced their right to recover reversions and the Financial Accounting Standards Board has taken steps to require that plan liabilities and excess funding be reflected on employers' balance sheets. Many companies justifiably view themselves as having bought and paid for excess assets as a result of acquisitions in which the purchase price was adjusted to reflect overfunding of plans assumed by such companies. In fact, in the recent AM International case the PBGC successfully argued that the net worth of AM International for Title IV employer liability purposes with respect to the termination of an underfunded plan should include the amount of the excess assets which would remain if another plan were to terminate. In Re: AM International, Inc., ____ F. Supp. ____, 5 EBC 2337, 2343 (N.E. Ill. 1984).

We are here to deliver a clear message. Any unjustifiable restriction on reversions will, without any doubt, result in fewer defined benefit plans. Employers will simply not commit themselves to a one-sided deal in which the rules are "heads we win and tails you lose."

2. Funding. Actuarial science is an imprecise science. It is unlikely that an employer's contributions when

combined with fund experience will actually hit the precise funding target. This is particularly the case when a plan terminates.

ERISA funding standards leave considerable latitude to a company to choose among several permissive funding methods. Actuaries have tended to err on the conservative side (that is, to require contributions on the high end rather than the low end within the range of reasonable actuarial calculations). They have done so with employer knowledge and acquiescence. Even the most confident actuary knows that 30 to 40 year projections of salary, employee turnover and investment rates are only best guess estimates. The present incentives towards generous funding are without doubt in the best interests of employees and retirees. Of course they are not the result of sheer altruism. Rest assured they are largely a function of a delicate balance in the present law between the rules regarding the tax exempt status of plan assets, the deductibility of contributions, minimum funding standards and the right to recover any reversion. To the extent that reversions are restricted, this delicate balance will be upset and the result will unquestionably be less generous funding to the detriment of plan participants.

Prior to termination, a plan's funding rates, methods and factors are conservatively established with a view to their long term reasonableness. For example, a long term funding interest assumption is typically several percentage points lower than current annuity purchase rates. However, when a plan terminates this long term focus telescopes into a current determination of the cost of purchasing plan benefits through fully paid up annuity contracts. This is the termination funding phenomenon which more than any other factor explains why plans with funding obligations prior to termination are converted into overfunded plans upon termination.

As long as there is flexibility in the actuarial rates and factors which may be used, employers cognizant of their fiduciary duties to shareholders not to waste corporate assets will only use prudent and conservative funding assumptions if any excess assets which result from such assumptions are recoverable in the event of a plan termination. Thus, existing rules encourage sound funding and diminish the risk to employees and the termination insurance system presented by the termination of underfunded plans.

3. Fair Distribution of Excess Assets. When an overfunded plan terminates, all participants, including those who are not yet vested, are immediately vested in all benefits accrued to the date of termination. Before any benefits may be distributed the plan administrator must make provisions to assure that all benefits are guaranteed by the purchase of annuity contracts or the actual distribution of those benefits.

If the plan provides for mandatory employee contributions any reversion must be shared with employees. Otherwise, if the plan so permits, the excess may be returned to the employer as taxable income.

Before the sponsoring employer may recover the excess assets it must assure the PBGC, the Internal Revenue Service and, where appropriate, the Department of Labor that neither ERISA nor the tax laws are being violated and that the plan authorizes such reversions. Under the guidelines issued in May of 1984, special standards apply to so-called "spin off" or "reestablishment" situations. These standards are designed to assure that employers do not benefit from reversions to the detriment of ongoing plans.

Advocates of a new policy do not usually state clearly their intention to deny employers the advantages of investment gains. Rather, they talk in terms of the right of employees or retirees to the benefit of such gains or the need to anticipate future cost of living benefit increases or increases due to future pay increases. However the position is stated, it is bad policy, it is unfair to plan sponsors and it is destructive of employees' and retirees' best interests.

While some companies may provide cost of living increases on an ad hoc basis, they do so when they see a need and desire to do so. They must either increase funding costs or use a surplus to pay for the increased benefits. In the event that an existing surplus is dedicated to such ad hoc increases, it is a voluntary decision and should remain so. No legislation should be adopted mandating such increases whether from surplus or any other source.

Similarly, future salary administration and plan design decisions should not be fettered by the concept that a plan design decision to base benefits on final pay is a permanent decision. Termination of a final pay plan should not trigger an obligation to anticipate and fund the benefits which would result from future pay increases. Employers should be free to exercise their reserved right to amend or terminate their plan at any date and fund only the benefits accrued at that time. Any other rule will at the very least bring to a rapid halt the practice of many employers of providing final average rather than career average benefits.

II. Is There A Basis For Development Of A Consensus View?

We encourage you to carefully study the terminations which have occurred to date to provide an accurate picture of the actual effects of such terminations. You should include information regarding new plans established thereafter. You may also wish to take note of the productive uses to which reversions have

been applied. We believe you will find that many reversions have been used in ways which create jobs and contribute to economic growth.

There is a growing basis for hope that common ground can be found between the conflicting views on this issue. Despite the early overstatements of the objections to reversions as a theft of employee funds, there are signs that the views of the opposing factions in this debate are tempering and are beginning to converge. We encourage this process.

The formation of this task force is the best evidence that this process has moved beyond the stage of an overheated political, social and media debate to a more serious effort at compromise.

Make no mistake about the Chamber's dedication to preserving the rights of employers to recover reversions. However, we realize that not all situations are the same. As the administration's policy pronouncement in May 1984 illustrated, not all plan terminations fit neatly within the traditional legal framework permitting reversions. We encourage the development of creative proposals to permit reversions with full protection of participant rights but without burdensome procedural barriers or possibly without a plan termination. In addition, we may be favorably disposed towards creative solutions which permit employers to utilize excess plan funds to provide other unfunded or underfunded employee benefits such as retiree health and life benefits.

We stand ready to work with the members of this panel and with any other group of serious-minded proponents of policy improvement. We would like to work with the members of this panel in good faith to help diffuse the overheated rhetoric which has marked this debate over the past three years.

Chairman PICKLE. Mr. Fay, thank you very much.
Now, Mr. Gulotta.

STATEMENT OF MICHAEL J. GULOTTA, PRESIDENT AND CHIEF ACTUARY, AT&T ACTUARIAL SCIENCES ASSOCIATES, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS [NAM], ACCOMPANIED BY VICTORIA CALDEIRA, ASSOCIATE DIRECTOR OF EMPLOYEE BENEFITS, NAM

Mr. GULOTTA. Chairman Pickle, members of the House Oversight Subcommittee, I am Michael J. Gulotta. I am president and chief actuary of AT&T Actuarial Sciences Associates, Inc.

I am appearing today in my capacity as a member of the National Association of Manufacturers Employee Benefits Committee. Accompanying me is Victoria Caldeira, who is NAM's associate director of employee benefits.

I would like first to address the administration's proposals concerning underfunded pension plans, and then the administration's proposal on the PBGC premium.

The NAM believes that the administration's proposal on pension plan funding gives balanced consideration to employee benefit security and the need to provide responsible employers with incentives to continue in the defined benefit pension plan system.

The proposed stricter funding standards will make more employers accountable for their pension promises. This is desirable, given the \$4 billion deficit of the PBGC.

Of the 115,000 corporate premium-payers who finance the PBGC, two-thirds maintain well-funded pension plans. This majority cannot be expected to continue to pay for 65 percent of the guaranteed benefits of those plan sponsors who terminate their underfunded pension plans. Companies with well-funded plans can no longer afford to absorb these added costs as employers must now compete in a world marketplace; nor can the Federal Government be expected to absorb the added costs.

Rising Federal budget deficits have directly contributed to the cumulative U.S. trade deficit of \$500 billion since 1982.

The need to improve U.S. competitiveness in a global economy is NAM's number one priority for 1987.

I would like now to address the administration's proposal for a PBGC premium, a variable-rate premium.

The NAM commends the administration for introducing a bill proposing a variable-rate premium. The NAM strongly supports the variable-rate premium legislation as it would further strengthen the defined benefit pension plan system, and it would also fairly allocate the costs of the single-employer pension plan insurance program. Without a variable rate, the premium all plan sponsors would pay could increase by as much as \$40 per plan participant per year, thus raising the premium to almost 50 times the original \$1 premium established in 1974.

The most critical issue in the debate over a flat-rate versus a variable-rate PBGC premium is the concern over the future vitality of the defined benefit pension plan system. And that vitality is highly correlated with the future benefit security of the tens of mil-

lions of current and future retirees who will rely on the defined benefit pension plan system for their financial well-being.

We recognize that a variable-rate premium alone will not prevent empty pension promises. As we have indicated earlier in this testimony, more stringent minimum funding standards are also required and must be implemented.

However, it is also clear that a variable premium structure will enhance the chances that pension promises will not be empty. A variable structure will encourage plan funding so that the dollars will be there to pay those promised benefits.

There is also no question but that the variable-rate premium structure would be a more equitable and more efficient premium structure. Higher per capita premiums simply are an unjustified tax on plan sponsors of well-funded pension plans.

Yet these same sponsors, these sponsors with well-funded plans, who are continuing to act responsibly are being penalized. This penalty results from higher and higher premiums due to the action of others who have not funded their plans properly or who have increased plan liabilities, they have increased plan benefits which could not, given financial circumstances, be adequately funded.

Unlike the flat-rate premium structure, the variable approach reflects reality. It reflects the reality that underfunded pension plans do pose a greater risk to the PBGC. And the logical appeal of such a variable-rate approach is easily recognized. And the internal inconsistency of a flat-rate premium is also equally obvious. A flat-rate PBGC premium is analogous to a life insurance company charging an 85-year-old male with a \$1 million policy the same premium as it would charge a 20-year-old female with a \$10,000 policy.

In conclusion, on the proposal for a variable-rate premium, the NAM believes that the PBGC has put forward a proposal which is based on a soundly conceived conceptual framework. The details may not be perfect, but the conceptual framework is sound.

While the NAM supports that proposal, we do have some reservations regarding certain details of that proposal. In particular, we do not believe that increases or decreases in the premium should be automatic. Instead, we believe that these matters should be considered by Congress.

The NAM will provide the committee with additional specific input with regard to the details of the PBGC's proposal as soon as possible.

The NAM appreciates the opportunity to testify on the administration's pension proposals. We hope we will be able to support the variable-rate premium bill, as well as the bill that eventually evolves concerning the funding and termination of defined benefit pension plans as whole-heartedly as the concepts we endorse today. And as I mentioned, we will be happy to work with you in the further development of legislation to that end.

Thank you.

[The prepared statement follows:]

STATEMENT OF MICHAEL GULOTTA, PRESIDENT AND CHIEF ACTUARY, AT&T COMPANY—ACTUARIAL SCIENCES ASSOCIATES, INC., ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

EXECUTIVE SUMMARY

The Administration's proposal on the funding and termination of defined benefit pension plans has been developed in response to concerns regarding overfunded and underfunded single employer defined benefit pension plans. Since 1980, 16 billion dollars in termination/reversions have taken place. During this time, the Pension Benefit Guaranty Corporation (PBGC), the agency that insures these pensions, has experienced a rising deficit that currently amounts to four billion dollars. The PBGC has indicated that this deficit has grown as a result of only a few claims for very large amounts. More than 76,700 company plan sponsors have well funded pension plans. These companies, through premium payments to the PBGC, currently must subsidize more than 65% of the guaranteed benefits of plan sponsors who terminate underfunded pension plans.

The Administration's proposal would allow employers to withdraw excess assets without requiring a pension plan termination, and require a cushion of assets in the plan to protect employee benefit security. It would allow employers to transfer, without current tax consequences, a portion of excess assets to fund for current retirees' health coverage. The minimum funding standards for single employer defined benefit pension plans would also be tightened. NAM supports the underlying concepts of this proposal as an important step toward encouraging optimal plan funding and strengthening the single employer defined benefit pension plan insurance system.

Chairman Pickle and Members of the House Oversight Subcommittee, I am Michael Gulotta, President and Chief Actuary of Actuarial Sciences Associates, Inc., appearing today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee.

Accompanying me is Victoria Caldeira, NAM's Associate Director of Employee Benefits. The National Association of Manufacturers is a voluntary business association of over 13,000 companies of every size and industrial classification, located in every state. Our members employ 85% of the workers in manufacturing employment and produce over 80% of the nation's manufactured goods. NAM also has an affiliation with 158,000 businesses through its Associations Council and the National Industrial Council.

The NAM thanks you Chairman Pickle and members of the Oversight Subcommittee for the opportunity to comment on the Administration's proposal on the funding and termination of defined benefit pension plans as well as the Administration's bill providing for a variable rate premium.

The Administration's Proposals Concerning Underfunded Pension Plans

The Administration's proposal on pension plan funding gives balanced consideration to employee benefit security and the need to provide responsible employers with incentives to continue in the

defined benefit pension plan system. The proposed stricter funding standards will make more employers accountable for their pension promises. This is desirable, given the four billion dollar deficit of the Pension Guaranty Benefit Corporation (PBGC). Of the 115,000 corporate premium payers who finance the PBGC, two thirds maintain well funded pension plans. This majority cannot be expected to continue to pay for 65% of the guaranteed benefits of those plan sponsors who terminate their underfunded pension plans.* Companies with well-funded plans can no longer afford to absorb these added costs, as employers must now compete in a world marketplace. Nor can the federal government be expected to absorb the added costs; rising federal budget deficits have directly contributed to the cumulative U.S. trade deficit of \$500 billion since 1982. The need to improve United States competitiveness in a global economy is NAM's number one priority for 1987.

We commend the Administration also for introducing a bill proposing a variable rate premium, based upon the risk that a pension plan has of terminating in an underfunded position and transferring that unfunded liability to the PBGC. NAM strongly supports risk-related premium legislation as it would further strengthen the defined benefit plan system by more fairly allocating the costs of the single employer pension plan insurance system. The NAM has not yet thoroughly reviewed the details of this particular bill, but will provide the Committee with more specific input as soon as possible.

*Data compiled by Pension Benefit Guaranty Corporation (PBGC).

We wish to bring to the attention of the Committee the fact that Title IV of ERISA section 4006 (a)(6)(C)ii, presently gives the PBGC the authority to establish in part a variable rate premium. The rates would be based on the amount of a plan's unfunded guaranteed basic benefits. Section 4006 also places boundaries on the amount of revenue that could be produced from a variable rate premium. However, in the conference report on ERISA, Title IV, conferees envisaged the eventual need of the PBGC to go beyond the limits presently set forth. It specifically states that the PBGC may exceed the section 4006 rate limitations and produce unequal amounts of premium income from different rate bases, given the approval of Congress. The conference report also states that the PBGC was designed to ultimately be self-financing and not a charge on the federal budget.

The Administration's Proposal Concerning Overfunded Pension Plans

The Administration's proposal allows withdrawals of excess assets from pension plans, without requiring a plan termination. It also gives employers the ability to transfer, without current tax consequences, a portion of the excess pension plan assets to fund for current retirees' health coverage. These concepts are also supported by NAM, as they will allow for the optimal use of excess assets without affecting the defined benefit plan promise.

We are especially supportive of the fact that the Administration's proposal does not require automatic cost of living increases or other restrictions on excess assets that would interfere

with management and collective bargaining decisions. Such restrictions would seriously undermine the basic social policy goal of encouraging the defined benefit pension plan system.

Many in Congress incorrectly use the deferred wages theory to justify increases in benefits subsequent to a reversion. It is necessary to point out that the pension benefits are the deferred wages. Any assets in excess of amounts needed to provide the benefits, are not deferred wages.

Defined benefit plans are a promise by the employer to provide a pension benefit, typically for the life of the employee-retiree and the spouse. The nature of the pension promise and obligation remains unchanged; the employer-promised benefit level is fixed. Often the level of benefits is set through collective bargaining. The benefit agreed to is known to the employee in advance and the employee has the ability to adjust his/her personal savings to complement Social Security and the retirement pension to assure economic security. In a defined benefit plan, the employer essentially bears all the funding and investment risk. The Internal Revenue Code permits employers to fund that pension promise through a trust. Pension plan assets accumulate in the trust for the purpose of providing promised benefits. To the extent such assets exceed the value of the promised benefits, these excess assets are rightfully the employer's. Any restrictions on the use of excess funds would be opposed by Broad concern about retirees and the inadequacy of the promised benefit should be addressed, if required, by Congress in the context

of social policy. This topic is not appropriate for consideration in the context of termination/reversions or pension funding policy. Revenue for such social policy should appropriately be from general revenues; corporations should not have to pay for what are perceived as inadequacies in the standard of living of our nation's elderly.

Recommendations for Improving the Administration's Proposal on The Funding and Termination of Defined Benefit Pension Plans

The NAM does have some specific concerns which we feel have not been adequately addressed due to the general nature of this proposal. Our support of the Administration's proposal is contingent upon the following clarifications being made:

Minimum Benefit Security. We have interpreted "minimum benefit security level" to mean no more than what is required for a plan to be fully funded for current accrued and probable future contingent benefits. This needs to be clarified in legislation. In addition, the interest rates to be used in determining "termination liability" must also be specified.

Controlled Group Liability. The application of controlled group liability in the context of sales of businesses presents a major problem. Certain safe harbors must be provided to assure that employers are not unduly restricted in their day to day business transactions. The funding status of the plan should be a primary

consideration in determining any such safe harbors. Language concerning controlled group liability is crucial to the NAM and hence to NAM endorsement. We would like to actively participate in the development of such language.

The process of evaluating plan asset sufficiency must also be simplified to deter adverse effects on business transactions. Employers should be permitted to use the most recent actuarial valuations already in existence. Without this ability, companies would have to undergo the lengthy and administratively complex process of determining valuations as of the date of the sale of a business. During this period many a potential buyer would be lost. This buyer would often represent the only viable option to a seller other than shutting down a division or a subsidiary.

The Department of Treasury recently suggested that companies involved in sales of subsidiaries would be required to treat excess assets as if a termination/reversion had taken place. Thus, companies would be forced to consider excess assets as income for tax purposes. This was not in the original Administration proposal. NAM opposes the inclusion of such a provision as it would artificially create income that does not exist under present law or generally accepted accounting principles.

Employer Securities in Floor-Offset Arrangements. Proposed restrictions on the use of employer securities in floor-offset arrangements must also be eliminated from the Administration's

proposal. The security of participants in these types of arrangements is more than adequately protected by Section 1175 of the Tax Reform Act of 1986. This section requires ESOPs to offer partial diversification elections, for up to 25% of a participant's account balance, to employees meeting certain age and participation requirements. At least three investment options must be provided. The percentage of an employee's account balance that can be diversified increases to 50% for employees age 60 or above.

If risk of loss to the PBGC is the concern being addressed here, additional premium payments to the PBGC would be a more acceptable alternative than outright restraints on the use of these arrangements. Such restraints are unfair to financially strong companies and their employees who view ESOPs as an important pension benefit.

Reasonable Transition Rules. The NAM has one additional concern that is of the utmost importance to our membership. Reasonable transition rules must be developed concerning the new stricter funding standards. The proposed new amortization requirements represent a drastic departure from current law. Consequently, a significant period of transition, to help companies with underfunded plans to meet the new standards, should be added to this proposal.

The NAM appreciates the opportunity to testify on the Administration's pension proposals. We hope we will be able to support the variable rate premium bill as well as the bill that eventually evolves concerning the funding and termination of defined benefit plans as wholeheartedly as the concepts we endorse today. We will be happy to work with you in the further development of legislation to that end.

Chairman PICKLE. Thank you, Mr. Gulotta.

It would seem to me that this panel has some reservations about the recommendations. I do not take it that you are opposed to it in its entirety, but you have kind of endorsed it with kind of faint praise.

Let me ask you first as an overall analysis, the GAO and the CBO and the PBGC have this morning come here and said that there is an imbalance between the income and the liabilities of a pension program. And as the GAO said, the program is in serious difficulty.

Do you disagree or agree with that analysis? Are we in trouble, or should we make some changes, or should we just ride through the storm and hope for the best? So my question to any one of you is do you accept the GAO's analysis that we are in serious difficulty?

Mr. GULOTTA. Mr. Chairman, I think the current situation is such that the PBGC can pay current claims, that is true. But before too long, we are going to find out that those liabilities have increased to a point where we are not able to cope with them. We need to do something about the PBGC's deficit problem today before it gets out of control. It is already getting close to being out of control.

With regard to—I want to make sure that the NAM's position is clear. We think that the PBGC has put forward an extremely good proposal. Its details, as I said, may not be perfect. But the conceptual framework, its general approach, is excellent. It is soundly conceived, and on a going forward basis, which is a real concern out there in the future—the size of that liability and the mounting deficits. On a going forward basis, it is an excellent approach. It will help solve the problem of going forward.

Chairman PICKLE. Let me ask are you all in general agreement that the proposal in general is a good one? I could not detect that from your testimony.

Mr. LABEDZ. The goals behind each of the proposals are laudable. We have problems with both proposals. On behalf of ERIC, we think that the minimum funding proposals is far too complex, and that the variable-rate premium proposal is too simplistic.

Chairman PICKLE. All right. If you think the minimum standards are too complex, do you have a recommendation, or would you submit that to us?

Mr. LABEDZ. One that I mentioned this morning was the possibility of accelerating the maximum funding period for unfunded benefits. Currently, it is at 30 years. If you were, without dislocating employers' businesses too severely, to reduce that maximum funding period to some number like 20 or 15 years, you would fund unfunded benefits much more quickly.

Chairman PICKLE. That has been recommended. But you are not—I am trying to establish that we do have a problem, we had better try to correct it now, and do not just rush into it, but try to make some correction—but among other things, the minimum funding is one approach to consider.

Mr. LABEDZ. You can pour all the premium dollars you want into the system, but if you have not fixed the hemorrhage at the other end, it is going to be a limitless problem.

Chairman PICKLE. If we continued to raise the premium alone—\$5, \$10; PBGC said at one time, under present conditions, I think, it might be as much as \$22—would that cause plans to be terminated? Would that have an adverse effect on the pension program?

Mr. ANDERSON. Mr. Chairman, let me suggest to you that at the margin, it will affect some plans. Now, how many it will affect in and of itself is a question about which we just have to guess. But there will be a plan, at least, or several plans, that look at and decide that that is enough to break their backs on the issue.

But perhaps that is not the real cutting edge of that question. Maybe the problem is, Mr. Chairman, that we have got a premium structure that has moved in 1977 from \$1 to \$2.60; last year it moved from \$2.60 to \$8.50; this year it is now proposed to move from \$8.50 to \$22.50. If the plan sponsors looks at that and extends out to the future, a logical progression of where the premium will be in 5 years or 10 years, that may be the element that gives the employer, the sponsor, the greatest reason to slow down and be cautious.

Chairman PICKLE. Well, Mr. Anderson, we have gone from \$1 to \$2.60 to \$8.50 because the liability has increased, and we are just trying to do something.

Mr. ANDERSON. Mr. Chairman, I am not laying blame at anybody's door. But the point is that the liabilities continue to grow, and the very best efforts that the very best minds can bring to this committee every year, to tell you what the liability will be in a year and next year, have been consistently incorrect. It is impossible for the best minds in Government to tell you how many plans will terminate next year and what the dimension of the liability that would be put to PBGC will be. We do not know.

Mr. FAY. Could I address—

Chairman PICKLE. Yes, Mr. Fay.

Mr. FAY [continuing]. The seriousness of the problem. The administration has provided some very interesting facts as part of their proposal. In exhibit C, they break down the funding of plans by industry. And that chart shows that in only one industry do liabilities exceed assets. In every other industry, assets exceed liabilities.

So we should not let the legitimate problems PBGC has right now blind us to the fact that we are dealing with a system that overall and almost uniformly, except for one industry, has very well-funded plans.

Chairman PICKLE. Well, Mr. Fay, I do not think we ought to be blinded to the fact, but neither do I think that you ought to be blinded to the fact that we have got a problem.

It would seem to me that the healthy, large, well-funded and operated pension plans would want to see some corrections made, rather than to just sit back and say we ought not make any changes, because you are the one that is going to be affected. You are going to be hurting more, because it is your money that is paying the premiums of these other companies. So I take it that you are not saying that we ought not to do anything; but when you say we ought not be blinded to the fact that the premiums are going to be increased, I recognize that, but I also recognize that you

have got a responsibility that is going to fall back on you if we do not do something.

Do you disagree with that?

Mr. FAY. My point was only that one should not be getting the feeling here that the American private pension system is in poor shape. It is in excellent shape. And yes, there are problems. That is why—

Chairman PICKLE. Well, most of you are. I think that is a good point. Most of the major companies are doing an excellent job. But we have still got a serious financial problem that has got to be corrected.

Mr. FAY. And a problem that, frankly, I think is transitional; it represents a change in economic conditions.

Chairman PICKLE. Well, that has been suggested, and maybe we can arrive at that conclusion.

Mr. FAY. The best way to summarize in the future is not going to be what it was.

Chairman PICKLE. Well, at the beginning, I had the feeling that you just did not think we ought to do anything, or at least, I think Mr. Anderson said he was appalled that the administration would make a recommendation of increasing premiums. And I am almost equally as appalled that you would want to just backslide a little bit on this thing and just hold your hands and let us see what happens. I do not think we can afford to wait and see what happens.

Mr. ANDERSON. Mr. Chairman, I have had reason in the last year or so to take a long, hard look at these issues.

Chairman PICKLE. Well, a year ago, you wanted to take a hard look at it, and as I recall it, you said we ought not do anything, but we ought to look at it. Now you want to look at it some more. You get to the point where we almost have got to take action and not just keep looking at it.

Mr. ANDERSON. Well, Mr. Chairman, if the PBGC was going to be running out of money, that might be the case. I think they have indicated that they have more than sufficient financing to carry themselves for a long period of time.

Chairman PICKLE. Well, we have got a \$4 billion deficit now and unfunded liability of \$45 billion. You say that is not a serious matter?

Mr. ANDERSON. No, sir. What I am saying to you is that if we look at the source of that unfunded liability, we will note that it comes from a very few plans that terminated last year, and they all happen to be congregated in one industry.

Chairman PICKLE. Mr. Schulze, let me recognize you, and then I will come back with other questions.

Mr. SCHULZE. Thank you, Mr. Chairman.

To follow along that line of questioning, it seems to me we have an economy under transition, and we in Government have to be aware of that. If we are to believe "Megatrends" and some of the others that say we are inexorably grinding toward a service-oriented economy, those of us who sit on this side of the desk have to be cognizant of those trends and prepare for them so we do not have a crunch.

So it seems to me that we have an obligation to not only be aware of these trends, but to do something about it.

I appreciate the testimony of the panel. I thought it was enlightening and stimulating. I appreciate the fact you took time to be here, and I have no more questions at this time, Mr. Chairman.

Chairman PICKLE. Thank you.

Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman.

I agree with the statements that the pension plans of most companies are in great shape. If you take a look at the percentage figures, it does settle down to a few companies in a particular field. But even more narrowly than that, what happened to a few companies within the final years of their death throes if we had anticipated it.

I believe my question would be, would you be supportive of some kind of language which would allow the PBGC to either disavow or step in in a way in which it could make decisions affecting guaranteed benefits that result from plan amendments subsequent to either a funding waiver or some kind of failure to make a minimum funding contribution within a 3-or 5-year period before they terminate? That is, provide some kind of guarantee against death throes decisions—any of you?

Mr. LABEDZ. Those are possibilities. There is another one that comes to mind, which underlies this problem, and that is that the PBGC guarantee phases in over 5 years' worth of benefit improvement. But the promise that the employer makes does not have to be funded for 30 years.

Obviously, there is a big gap there. That is another possibility.

Mr. THOMAS. You have talked about shortening that time frame.

What about shutdown benefits in general? Should PBGC guarantee them at all?

Mr. GULOTTA. I do not have a comment on shutdown benefits, but I did want to address the previous question.

Mr. THOMAS. Sure.

Mr. GULOTTA. I think, looking at the size of the PBGC guarantee is one matter. But behind that PBGC guarantee, there is the issue of did the employees get the benefits they were promised—regardless of the existence of the PBGC. The employees had a right to expect that these promises were going to be fulfilled, and they did their financial planning on this basis.

The PBGC guarantees are cut back—well, then, not only has the employer's promise become empty, but the PBGC promises become less of a promise.

So I think the real answer to the bigger problem is that we have got to incent companies that, if they make promises, that they should fulfill those promises. If they tell their employees that they are going to receive a certain pension, then those pensions should be made good for; they should be funded. So we have got to create the incentives and the requirements to fund, and only a combination of a strengthened minimum funding standard and a variable-rate premium, together—we need both—neither one or the other will work alone. We need both. But the point I wanted to make was that you need those first, because you really ought to fulfill the pension promises. No one should go through their careers expecting that they are going to retire on a certain level of income and plan their lives that way and then be subjected to the kind of

trauma that they would be subjected to because the plan does not have enough money, the employer has not put the money in, and the PBGC cannot handle it.

Mr. THOMAS. Well, Mr. Gulotta, it just seems to me that you have a little more faith in the collective-bargaining system than I do. Because if the unions were negotiating and they had a pretty good understanding of where the company was, and some of the promises that were made probably were pretty clearly not deliverable, but since you have a third party on which you can dump those obligations, then it is easier for those other two parties to make agreements. I believe that is my biggest concern about amendments that are made.

So it is not so much that we have made a promise to employees, and they have planned their futures on it. It is that as you are going down, you grab anything you can to try to stay afloat. Agreements are made which I believe both parties are pretty knowledgeable that neither one is going to be able to deliver on, except that we have this program that they can fall back on. So that is my concern in terms of focusing on the studies that we have from GAO.

I understand that you probably need an adjustment of both, but I would like to ask my question, of perhaps Mr. Anderson or Mr. Fay. If you had the ability to focus on one or the other—higher premiums or a stricter funding standard, which one would you choose?

Mr. ANDERSON. Mr. Thomas, I believe I would be inclined to look at the stricter funding requirements as a first step, and further consider what my decision would be with regard to premium increases.

I think what may be missing in the equation here—and there were several questions asked this morning of the GAO auditors with regard to the nature of the experience that has given rise to these requirements for premium increases—I think if that is to be probed, you may well find that there is a fairly clear profile presented in terms of the kind of benefit provisions, the environment within which the plans are operated, the financing mechanisms that are chosen to fund the plans. And it may well be that on the basis of that analysis, instead of a shotgun approach to plans in general, you may be able to tailor some fairly specific remedies.

Mr. THOMAS. I do believe that if some of us are in trouble, then all of us are in trouble. But if we started a program in which some programs were underfunded to begin with, that if we tighten up on the funding standards, then there will be a few who have well-thought-out programs that will have to pay the premiums to pay for those who do not have well-thought-out programs.

Mr. FAY. Can I answer your question also, Mr. Thomas? First, we also would favor the tightening of funding requirements and funding waivers rather than monkeying around with the premium level, trying to do something indirectly. In fact, I think it is unfortunate that we all seem to be concentrating on PBGC's problem, because our analysis should start at the beginning of the problem, not at the end of the problem.

As to other things that could be done, one of the points in my statement is that the chamber would certainly think it might be reasonable to consider the possibility of, when a plan is very poorly

funded, of not allowing any more benefit increases or to provide that certain benefits would not be guaranteed benefits.

Finally, if I may just make a commonsense observation, the premium has to be thought of as really a short-term, revenue-raising measure. A statement saying that if we do this or do that, we are encouraging people to fund their plan or not fund their plan is just silly, as the witness earlier today said that for a poorly funded plan, it would be much more reasonable for them just to pay that additional premium rather than do sound funding.

So the approach has to be, if you think there is a problem, it has to be at the funding part.

Mr. THOMAS. I agree.

Thank you very much, Mr. Chairman.

Chairman PICKLE. Thank you, Mr. Thomas.

We are going to submit to each of you a series of questions we would like you to respond to. Assuming that we need to make some changes, the question then is how do we go about it. I want your position—would you increase the premium to another level, or how much would you increase it? Or, as Mr. Thomas asked you, if you could do that and not have the variable, which would you want? I would want to know from you, if you increased the premium, would it cause plans to terminate—and can you do just one or the other or, as Mr. Gulotta says, could you go to minimum funding and the premium both—I mean funding standard and so we are going to submit a series of questions to you so you might respond to us.

I am encouraged that, rather than the statements you made to begin with indicated you just did not think we ought to do anything, a further consideration leads me to believe that you are saying yes, we do have a problem, and you do not think it just ought to be settled in premiums alone, and several refinements ought to be made in Treasury's recommendation. And we would like to study your testimony and consider it as we look at this program.

I am not going to disagree with Mr. Labedz, who said we ought to consider factors such as the size of the pool, how to fix the holes, and where to get the water. Another factor is how many people would drown as we start thinking about these holes, and whether we have got water in the pool. That is, quote, the bottom line that we must look at. So as we consider these factors, we would like to have your further comments.

I think this committee is seriously considering some way to try to shore up the funding problems. Now, we know that the difficulties in the last 3 or 4 years have been primarily in the steel industry; one of you made that observation—and that is true. And you will say, well, let us wait and see what happens. There are a lot of problems out in the steel area yet that have not been accounted for. We do not know what is going to happen. This is not the end of the road just in that one area alone. And for us to say, well, the worst has already happened, is just fagciful wishing, perhaps.

So I want us to be as practical as we can, and what you have given us today has been helpful, and we will study it, and we hope we will find that it is positive.

So we thank you very much.

The next panel will include John Rother, Jacob Clayman, and Karen Ferguson.

John Rother represents the American Association of Retired Persons; Jacob Clayman is president of the National Council of Senior Citizens, and Karen Ferguson is director of the Pension Rights Center.

We will hear first from John Rother, if you will proceed, sir.

STATEMENT OF JOHN ROTHER, DIRECTOR OF LEGISLATION, RESEARCH AND PUBLIC POLICY, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. ROTHER. Thank you, Mr. Chairman.

As you know, the AARP now represents over 25 million members age 50 and above, and we have long been concerned with the fairness, security and adequacy of the private pension system.

I would like to say we do have a complete statement, which I would submit for the record, but I would like to call the committee's attention to not just the problem of underfunding that we have been talking about this morning, but also to the problem raised by the situation concerning overfunded pension plans.

We commend the administration for making a serious attempt to address the problems of pension overfunding and underfunding. Their proposal constitutes a solid conceptual foundation for needed legislation in this area. However, we believe the administration's proposal is inadequate in several respects.

Mr. Chairman, first, I would like to outline the three criteria that we would use to evaluate their plan. First, plan participants, workers and retirees, should have an equitable interest in the assets built up in a plan. In other words, at least part of the so-called surplus belongs to the plan participants.

Second, allowing withdrawals from ongoing plans makes sense only as a disincentive to plan terminations. Therefore, terminations must always be less attractive than withdrawals.

And finally, if withdrawals are permitted, there must be a cushion above full funding levels to guard against asset fluctuation and to allow for future benefit improvements.

Unfortunately, we find that the administration's proposal fails to fully satisfy these principles. It does not recognize the equitable interest of plan participants. In fact it is based on the idea that all of the assets belong to the employer.

While the proposal does allow withdrawals—a radical departure from current law—it does not sufficiently discourage terminations.

Many plan sponsors will find that they can get greater amounts out of the plan if they terminate rather than if they take a withdrawal. And I would like to call your attention to my right. We have a chart which graphically illustrates this. This chart assumes that the surplus equals 100 percent of termination liability, and—

Chairman PICKLE. Mr. Rother, I cannot see that chart. Is that a part of your testimony?

Mr. ROTHER. It is attached to the testimony at the back.

Chairman PICKLE. I see it now. Go ahead, Mr. Rother.

Mr. ROTHER. It shows the situation at termination, and compares it to withdrawal under the administration's plan, and it shows why under certain circumstances, termination might be much more attractive to an employer. We do not think that that is proper policy to put into our pension law.

Finally, the cushion required in the administration plan is not sufficient. It does not fully protect the benefit security of plan participants.

Mr. Chairman, our recommendations are that, first, on withdrawal, the cushion left in the plan should be an additional 10 percent above the administration proposal. This cushion would remain in the plan to protect against investment fluctuations and to leave open the possibility of future benefit improvements.

Second, on termination, the cushion amount would be paid out as benefit enhancements to plan participants, both workers and retirees. In addition, a 20-percent excise tax would be imposed on any reversion amount. This combination makes terminations much less attractive than withdrawals and recognizes participants' equitable interest. The second chart, again attached at the end of our testimony, illustrates this point.

Finally, I would like to say that we approach any departure from ERISA's exclusive benefit rule with great caution. Any change must ensure greater protection for plan participants and greater security for the pension system as a whole.

We believe it is inappropriate to permit pension plan funds to be used for other welfare plans, including retiree health plans, before basic retirement income needs are met.

Therefore, we believe that plan assets should be used in the following order: first, to satisfy the security of the participants of the original pension plan; second the security of the participants of other pension plans of the same employer; third, the security of participants of retiree health plans of that employer, and then, fourth, the reversion of the employer with the appropriate excise tax.

Now, the administration's proposal also addresses the need to strengthen minimum funding rules. The question is whether the proposal overfixes that problem.

Since details are not fully available, I am simply going to note some questions. First, appropriate transition rules will be needed to protect currently troubled plans.

Second, funding rules should not restrict the establishment of new defined benefit plans nor hamper the ability of plans to grant benefit improvements.

And third, the problem of actuarial reasonableness and plan assumptions needs to be addressed.

Underfunded plans are still in the minority, and terminated underfunded plans are small in number. PBGC's increased deficit is primarily the result of a few large terminations in the steel industry. We believe any solution must recognize the isolated nature of that problem. Steps which assure adequate funding before problems develop should be taken now, but without overburdening the entire pension system.

The wave of terminations, both underfunded and overfunded, which was taken place in this decade threatens to undermine confi-

dence in the private pension system. We believe the time has come for responsible legislation remedies to make good the promise of ERISA that when a pension is promised, it will be there when needed.

Thank you, Mr. Chairman.

[The prepared statement and attachments follow:]

STATEMENT OF JOHN ROTHER, DIRECTOR, LEGISLATIVE RESEARCH
AND PUBLIC POLICY, AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) is the nation's largest membership organization, representing the interests of 25 million members age 50 and above. The Association is pleased to testify today on the Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans (hereafter the Proposal).

AARP commends the Administration for its efforts to address the problems of overfunding and underfunding in pension plans. The Proposal is a responsible attempt to deal with problems that threaten retirement benefit security. Nevertheless, the Association believes modifications are necessary to ensure a solution more consistent with good pension policy.

I. PRIVATE PENSIONS STILL NOT SECURE

The ultimate goal of changes in the income support structure serving retired Americans must be the establishment of a minimum standard of living for all older persons and a reasonable guarantee of adequacy, stability and security of retirement income so that individuals can plan for economic security in their later years. To be adequate, a retired person's income should be sufficient to prevent a significant decline in the living standard achieved earlier in life. Social Security is the basic foundation for retirement income planning. But to achieve the adequacy goal, Social Security must be supplemented by income from other sources, particularly private pensions, employment, savings and other income-producing assets.

The private pension system has grown dramatically over the past generation, but it must continue to expand in order to better meet the retirement income needs of older Americans. While the Employee Retirement Income Security Act of 1974 (ERISA) stands as the watershed of pension benefit security, recent events have pointed to deficiencies in the law that could severely undermine the security of the pension promise.

II. THE PROBLEM

The first disturbing trend has been the recent wave of pension plan terminations for the purpose of recovering so-called "excess" assets. While terminations for reversions were rare before 1980, since that time, well over \$10 billion covering over 1 million plan participants have reverted to employers. The tremendous stock market boom, along with other economic factors, has currently raised pension assets to about \$200 billion more than is presently required by the ERISA minimum funding standard, thus creating a tempting pot of money that threatens the stability and integrity of the private pension system.

A second problem is the recent trend in terminations of several large, significantly underfunded defined benefit pension plans. Neither the employer, nor the Pension Benefit Guarantee Corporation (PBGC) is currently liable for all unfunded benefits; thus, many plan participants have not received their full promised benefits. These terminations have also increased the strain on the financially troubled PBGC, which generally assumes terminated underfunded plan liabilities.

III. PRINCIPLES FOR REMEDIAL LEGISLATION

In order to correct these weaknesses, the Administration has proposed a broad and interwoven solution to the problems of overfunding and underfunding. Comprehensive in scope, the proposal also embodies a radical departure from ERISA's current rules, particularly the "exclusive benefit" rule. To determine whether a departure of this kind is both an effective solution and consistent with basic tenets of private pension law, this proposal must be considered against the following principles, which AARP puts forth as a framework for remedial legislation:

1. "Equitable interest" - Part of the assets built up in a pension plan, established with tax incentives in order to promote adequate retirement income, belongs to plan participants.
2. Funds in any pension plan have been put there for the "exclusive benefit" of that plan's participants, and the security and integrity of that plan must be foremost protected.
3. A "withdrawal" of pension fund assets makes sense only as a less onerous alternative to plan termination; therefore, terminations should be discouraged and always made less attractive than withdrawals.
4. In any withdrawal, a plan should be left fully funded, and must also include an added "cushion" to guard against asset fluctuation and to promote benefit enhancement.
5. Pension law should encourage present and future benefit security, including plan continuity, adequate funding, and benefit enhancement.

IV. ADMINISTRATION PROPOSAL- ACCESS TO PLAN FUNDS

a. Reasons for Change

The Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans (Proposal) correctly identifies the problems of current law under the Asset Reversion Implementation Guidelines (Guidelines). The Guidelines, instead of slowing the trend of terminations for reversions, formally allowed such practices as "termination/reestablishments" and "spinoff terminations." In both these transactions, a remaining or reestablished plan is generally stripped of any assets above the plan's termination liability. There are no restrictions on employer use of these recaptured assets. The net result has been to encourage terminations.

The Proposal squarely recognizes that change is needed because the reserve of assets above the plan's termination liability--any "cushion" -- is eliminated. The Proposal is completely on point when it reasons: "The absence of this cushion reduces participants' benefit security with respect to future benefit accruals and may also discourage employers from granting ad hoc benefit increases or cost of living allowances for retirees." (Proposal, pg 5).

The Proposal also correctly reasons that it is poor policy to allow an employer who has both well-funded and underfunded plans to benefit from reversions from tax-favored retirement funds while other plans of that employer remain underfunded. Current law does not require that the remaining plans of the employer recapturing assets be adequately funded.

b. Proposed Change

The Proposal would allow a radical alternative in its attempt to resolve the problem of terminations for reversions. To halt outright terminations, the Proposal sets forth a "withdrawal" option. An employer would be permitted to withdraw assets from an ongoing plan if the following conditions are met:

- the plan is maintained at the new "minimum benefit security level" (the so called "cushion")
- all other plans of the employer, in the aggregate, exceed the "minimum benefit security level"

The "minimum benefit" security level" -- the "cushion" -- would equal the greater of:

- 125 percent of the termination liability

OR

- the "full funding amount" of the plan (the point at which the minimum funding rules require no additional contributions for the year)

However, the Proposal would permit a substantially reduced cushion for any annuitized benefits.

The Proposal would continue to allow terminations, but would limit the amount an employer may recover to the "permissible reversion amount":

- If the employer continues to sponsor other underfunded defined benefits plans, the permissible reversion amount would equal the same as for a withdrawal (that is, amounts above the cushion), but the cushion itself would be allocated to the remaining defined benefit plans.
- If the employer has no other defined benefit plans, or other adequately funded plans, the permissible reversion amount would be all assets over termination liability (the entire cushion). Thus, a termination in this instance would allow the same reversion as current law.
- The only disincentive added is that an employer leaving the defined benefit system entirely would be precluded from establishing a defined benefit plan for those employees for five years (the so-called "5-year curse").

V. ANALYSIS-ACCESS TO PLAN FUNDS

ERISA was adopted at a time of concern for plan underfunding, while the current trend of overfunding in plans is the result of a unique set of economic events (stock market, bond market, interest rates). This is illustrated by the fact that before 1981, such terminations for reversions were rare (only \$18 million in 1980), while now, they have become a part of corporate boardroom strategy (over \$10 billion since 1980). While the trend is new, and may only last a short time, it is clearly capable of repetition, and must be curtailed in order to protect plan security and the integrity of the pension system. In order to curb this abuse, the law can either: (1) prohibit terminations for reversions, (2) encourage withdrawals and/or (3) discourage terminations for reversions.

a. Withdrawal Option

The first question that must be answered is whether a "withdrawal" option is warranted. Current ERISA law, as well as general trust law, clearly prohibits a sponsor from withdrawing money from a plan that is intended for the "exclusive benefit" of others.

The only reason for a departure from this basic principle would be to correct a flaw in the current system. Such a flaw exists since current law, which is premised upon maintaining the voluntary nature of the private pension system, gives all employers the option to terminate a pension plan and recapture assets above termination liability. Under current law, not only does the

employer receive the benefit of a plan windfall, but the employee suffers the adverse effect upon termination of the loss of the benefits of plan continuity. (For further information, see the attached study, "The Impact of 'Overfunded' Pension Terminations on Workers.")

Current law is thus clearly inadequate. Since a prohibition of plan termination is inconsistent with the voluntary nature of the pension system, a withdrawal option must be considered.

The second question then becomes what type of withdrawal is appropriate. Returning to the principles set forth above, any withdrawal must recognize that:

1. part of the assets in the fund belong to participants;
2. it is only appropriate as a disincentive to termination; and
3. a fully funded plan, with an adequate cushion, should be maintained.

While recognizing some of the basic problems of withdrawals, the Administration Proposal does not go far enough in adhering to these principles.

First, there is no acknowledgment that any of the funds in pension plans, or any of the return on the equity of the plans, belongs in some part to plan participants. In fact, the very basis of the Proposal's withdrawal and termination options is just the opposite: that despite the tax incentive, and despite the "exclusive benefit" rule, pension plan money belongs to the employer. Thus, there is insufficient recognition of the "equitable interest" of plan participants in assets accumulated in the plan.

Second, the withdrawal option under the Proposal is not necessarily a disincentive to termination. In many instances, the amounts to be recaptured in a withdrawal are nearly equal to that of a termination. Worse yet, the employer may still be able to recapture more assets in some terminations than in the withdrawal option. This is true where the employer has only one plan or other plans are adequately funded. Since the withdrawal option does not always discourage terminations, in many instances it will serve only as a legitimate sanction to withdraw assets without serving any useful disincentive function. Stronger disincentives to termination than those embodied in the Proposal are needed.

Third, the Proposal does not leave a sufficient cushion to adequately protect the original plan participants. First and foremost, the participants of the plan from which money is withdrawn must be fully protected. Because the withdrawal option is so radical a departure from basic pension law, we should, if anything, err on the side of benefit security. Because each plan embodies a different set of employees, and often a different set of promised benefits, it is essential that the employer's promised benefits are not compromised. The Proposal suggests a cushion equal to the greater of 125 percent of termination liability (an arbitrary approximation) or the full funding amount of the plan (generally higher). The full funding amount is a superior starting point, since on a plan specific basis that amount is based on both earned benefits and projected benefits of an on-going plan. However, the full funding amount does not completely recognize the needs of that plan's participants. In addition to the full funding amount for active participants, an appropriate cushion should incorporate two other factors:

- the need to guard against asset fluctuation, and
- the need to maintain assets to enhance benefit security, including benefit improvements and ad hoc retiree adjustments.

The Proposal would permit a substantial reduction in the cushion amount if the benefits are annuitized. The cost of annuitizing benefits is a major factor in determining excess asset amounts. When interest rates are high, and the cost of an annuity is inexpensive, less assets are needed to cover plan liability. The result is that the low cost of annuitization may fuel the increase in assets. To reward standard industry practice in the event of withdrawals (or terminations) by also allowing a lesser cushion is inconsistent with the need to maintain an adequate cushion for future benefit security. Shifting of retirement income security from well-funded pension plans to individual annuities should not be encouraged. In addition, withdrawals themselves should be limited by requiring a larger cushion amount.

The "controlled group" concept for determining whether a withdrawal will be permitted will generally increase the cushion and therefore improve benefit security. The aggregation requirement for withdrawals will also prevent an employer with largely underfunded plans from recapturing assets from any overfunded plans. In instances where there is one plan (or other adequately funded plans), however, the controlled group concept will not increase the protective cushion, and additional amounts above the full funding amount are more essential. Even in the controlled group concept, the benefit security of the original plan is compromised when there is no recognition of the benefit promises made by that plan (often different from the promises made by other plans) to that set of employees. Leaving the original plan with only the full funding amount denies that any special relationship exists between the employer-sponsored plan and that plan's participants. In effect, the "exclusive benefit" rule is washed away, and future benefit security and benefit expectation for that plan's participants is jeopardized.

b. Termination Option

The third question, assuming an acceptable withdrawal option and cushion, is what type of termination recapture is appropriate. While the Administration's proposed withdrawal option is based on a conceptually workable set of principles, the termination option as proposed is inadequate. Again, returning to our principles, any termination must recognize that:

1. part of the assets in the fund belong to plan participants;
2. the "exclusive benefit" of that plan's funds must be primarily maintained for those participants' benefit security; and
3. the termination itself must be strongly discouraged.

First, there is again no acknowledgment that any of the pension plan money belongs to plan participants. While the withdrawal option at least recognizes that a cushion must be left for benefit security and benefit enhancement, the termination option completely ignores the concept that plan funds above termination liability belong to the participants of the terminated plan. Two basic facts are disregarded in determining how to divide assets in a termination: pension contributions are part of the entire salary package, and a tax advantage has been conferred for the purpose of benefitting those participants in the plan. This

disregard for the participants' equitable share is especially true where an employer leaves the defined benefit system, in which case the recaptured amount will be the same as current law. Thus, no solution or deterrent is even offered to remedy a recognized problem.

Second, the Administration's Proposal would ignore the "exclusive benefit" rule entirely in a termination and require the terminated plan to transfer assets above the termination liability to other underfunded plans. This would effectively give the employer the same reversion amount as under a withdrawal, but at the same time disregard the future benefit security of the terminated plan's participants. The proper funding of other employer plans, already an obligation of the employer, would be addressed by taking assets from a plan where benefits were promised to a different set of employees. The employer, by dipping into this newly-formed pension pool, can gain a windfall through a reversion from one plan, relieve an already existing obligation to another plan, and leave the participants of the first plan with less benefit security, even if a new plan is established. The simple result is that the participants in the terminated plan--who have believed they were in a plan that was ongoing, well-funded, and a source of future benefit security -- may now be worse off. Participants are hurt because their plan did better than expected in the short term snapshot view based on termination liability.

This transfer of assets again ignores any return on equity for participants of the terminated plan, and does not recognize the primacy of the future benefit security of that plan's participants. In fact, assets may be transferred to plans that have much higher benefit promises, and therefore greater liability, at the expense of participants of a plan in which money was originally intended for their exclusive benefit.

Third, the Proposal does not create sufficient disincentives to plan termination for reversion. Pension law should encourage both the formation of pension plans and the benefit security of those plans in existence as well. By maintaining termination as a comparable option to withdrawal, or in some instances an even better option as a means to recapture funds, the Proposal fails to solve the very problem this Proposal should address -- the termination of pension funds merely to recapture assets. Since a withdrawal option is created to allow employer access to plan funds, the termination option should be used only by plans that wish to terminate for reasons other than the recapture of assets. Therefore, recaptured amounts should always be less in a termination than a withdrawal, and penalties upon termination should be higher.

VI. AARP RECOMMENDATIONS- ACCESS TO PLAN FUNDS

Based on the framework established by the Administration Proposal, and guided by the set of principles already discussed, AARP recommends the following modifications to the withdrawal and termination options.

a. Withdrawal Option

In our view, the law should recognize that part of the assets in the fund belong to plan participants. In order to provide adequate protection against asset fluctuation, and to maintain assets needed for benefit enhancement, an increase in the minimum benefit security level (the "cushion") beyond the "full funding amount" is needed.

AARP recommends a 10 percent increase in a withdrawal cushion to the greater of:

- 135 percent of termination liability

OR

- 110 percent of the "full funding amount"

The plan aggregation rule would continue to be used to determine withdrawal availability. However, a reduction in the cushion would not be allowed for annuitized benefits. Annuitization is often part of the reason for the large surplus (due to low cost from high interest rates), and should not be used as a further incentive to lower the cushion. The 10 percent excise tax would also be maintained.

b. Termination Option

In our view, the law should recognize that part of the assets accumulated in the plan represent a return on equity and that the integrity of the plan -- whose purpose is the exclusive benefit of that plan's participants -- must be maintained. In addition, the termination itself should be discouraged.

AARP recommends that, in a termination:

- assets required to remain in the plan in a withdrawal (the cushion) be paid out to plan participants
- a 20 percent excise tax be imposed on the reversion amount

While plan aggregation is good policy in determining withdrawal availability, there are less compelling reasons in a termination. Mandated asset transfers between plans runs counter to the exclusive benefit rule. AARP is mindful of the problem of underfunded plans, but mandated asset transfers between plans undermines a basic ERISA protection and may raise more problems than it may solve. (For example, what is the proper fund transfer where plans have widely varied levels of promised benefits). A two-step approach, in which employers are required to fund-up any plan in a controlled group before taking a reversion, should be explored. Special rules involving the transfer of plan sponsorship beyond the controlled group will also need to be developed.

A 20 percent excise tax is recommended in order to further discourage terminations as compared to withdrawals. In addition, consideration should be given to earmarking part of the excise tax to the Pension Benefit Guarantee Corporation (PBGC).

Further, AARP questions the need for a "5 year curse," fearing that employees may be hurt by such a prohibition. If a moratorium on new defined benefit plan establishment is necessary to prevent abuse, a shorter period may suffice.

c. Transfers to Other Plans

In part, the Proposal mandates asset transfers in some instances, while allowing excise tax forgiveness for other transfers, particularly transfers to retiree health plans. The Association believes the problem of unfunded retiree health benefits is a major problem that requires a comprehensive solution. In this regard, this Proposal should in no way be seen as remedy for the large unfunded liabilities of retiree health plans. Further, AARP believes it inappropriate to permit pension plan funds to be

used for other welfare plans such as retiree health plans before basic retirement income needs are met.

Therefore, AARP proposes, as a general guideline, the following hierarchy for the division of any remaining plan assets:

1. the security of the participants of the original pension plan;
2. the security of the participants of other pension plans of the employer;
3. the security of participants of retiree health plans of the employer; and
4. the reversion to the employer, with the appropriate excise tax.

VII. ADMINISTRATION PROPOSAL - MINIMUM FUNDING

a. Reasons for Change

The Administration Proposal also includes substantial changes in the minimum funding standards for pension plans. Change is needed because current law does not fully insure that plans will have sufficient assets to pay participants' benefits. As a result, unfunded liabilities have in many cases threatened the benefit security of plan participants as well as increased the financial strain on the PBGC.

b. Proposed Change - Underfunded Plans

The Proposal would, for underfunded plans, generally shorten the amortization period for existing unfunded accrued liabilities, benefit increases, experience losses, and funding waivers. The new amortization period will generally be determined by looking at the funding status of the plan and the maturity of the plan's liabilities. (Details on assumptions and methods are not yet developed).

The Proposal would also require a minimum contribution -- the cash flow rule -- equal to the total distributions paid by the plan during the year.

c. Proposed Change - All Plans

The Proposal would also require all plans to comply with certain changes. Specifically, liability for contributions would fall on the controlled group, the timing of contributions would be increased, minimum funding waivers would be restricted, deduction limits would be revised, and employer liability would extend beyond benefit commitments to termination liability.

VIII. ANALYSIS - MINIMUM FUNDING

a. Stricter Funding Standards

As recent events have demonstrated, and the PBGC's increased deficit proves, the minimum funding rules need to be strengthened. The question is whether the proposed solution goes beyond the scope of the problem. Since details are not fully available, AARP notes some potentially troublesome questions.

The biggest problem area may be that of plans currently in trouble. To the extent plans are now underfunded and therefore unable to absorb the change to a shorter amortization period, stiffer funding rules may force these plans over the edge. Appropriate transition rules will need to be developed to safeguard these plans.

Second, since the new rules require much stricter funding, the establishment of new defined benefit plans may be severely hampered. This is especially true where new plans attempt to provide credit for past service. To the extent such liabilities prove too great under the new funding method, past service credit may not be feasible. This results in a disincentive to more comprehensive plan coverage. For similar reasons, any type of benefit enhancement, for both new and old plans, may be unnecessarily discouraged. Funding rules should not be so strict that the costs of benefit improvements become unreasonable.

A third problem left unresolved is that of actuarial reasonableness in plan assumptions. As long as plans are free to use wide parameters of reasonableness, there will be great variation in plan funding, and continued opportunity for abuse.

b. PBGC's Increased Deficit

A recent report generated by the General Accounting Office ("Government Insurance Program Threatened by Its Growing Deficit," March 1987), corroborated by the PBGC's Annual Report for FY 1986, points up the need to resolve these three major problems, as well as to institute improved and preventive monitoring of plans before they develop serious underfunding problems.

PBGC's deficit problems have essentially arisen from problems experienced by 33 plans of 23 employers, and especially from a handful of steel companies, primarily within the last fiscal year. According to the PBGC Report, eight plans constituting less than 1 percent of all claims have accounted for nearly 68 percent of total net claims. The FY 1986 claims of but two sponsors account for 83 percent of the PBGC deficit, with claims of one alone accounting for 54 percent of the \$3.9 billion for all single employer plan claims made since 1974.

It is instructive to note that the aggregate liabilities of steel industry terminations are responsible for 80 percent of the 12-year PBGC deficit, with the majority of these liabilities having occurred within the past 16 months; the net claims resulting from the remaining 96 plans that terminated during this latter period accounted for \$491 million. It is also instructive to note that, despite the new premium rate having been in force for only five months, FY 1986 premium revenues increased by a multiple of 2.25 times over FY 1985. Similarly, investment and other PBGC income nearly doubled in the same time period.

Looking to the future, proposals for some type of risk related premium, including variable rates, will not make up for the steel industry-created PBGC deficit. If enacted, a risk-related premium would put this existing burden on already troubled plans. Such a burden will likely cause some plans to terminate, thereby increasing the total number of participants owed guaranteed benefits. Such proposals also do not provide for adequate monitoring to avoid future problems that may occur, but that are unlikely to duplicate the unusual circumstances and magnitude of the problems of the past two years.

c. Proposed Measures

The Proposal does set forth several changes that AARP can support. If underfunded plans are still small in number, and confined to certain sectors of the economy, then drastic changes may not be essential. Any solution to the underfunding problem should avoid overprotecting the PBGC at the expense of the private pension system. With this as a guideline, the following measures, for example, should promote benefit security without overburdening the pension system:

- the cash flow rule - a yearly minimum contribution equal to total yearly distributions should increase plan security;
- control group liability - all related employers should be liable for contributions required by the minimum funding standards for all plans maintained by the group;
- timing of contributions - while speeding payments up to a quarterly basis may not be needed, certainly requiring earlier payments, as well as an earlier final payment, will provide a quicker signal if adequate funding is a problem;
- restricting funding waivers - requiring that waivers be determined on a controlled group basis is consistent with insuring that a real and temporary hardship exists; in addition, notification to plan participants should always accompany plan action; and
- extension of employer liability - the employer should be liable for the full level of the plan's termination liability, including all fixed and contingent accrued benefits.

IX. CONCLUSION

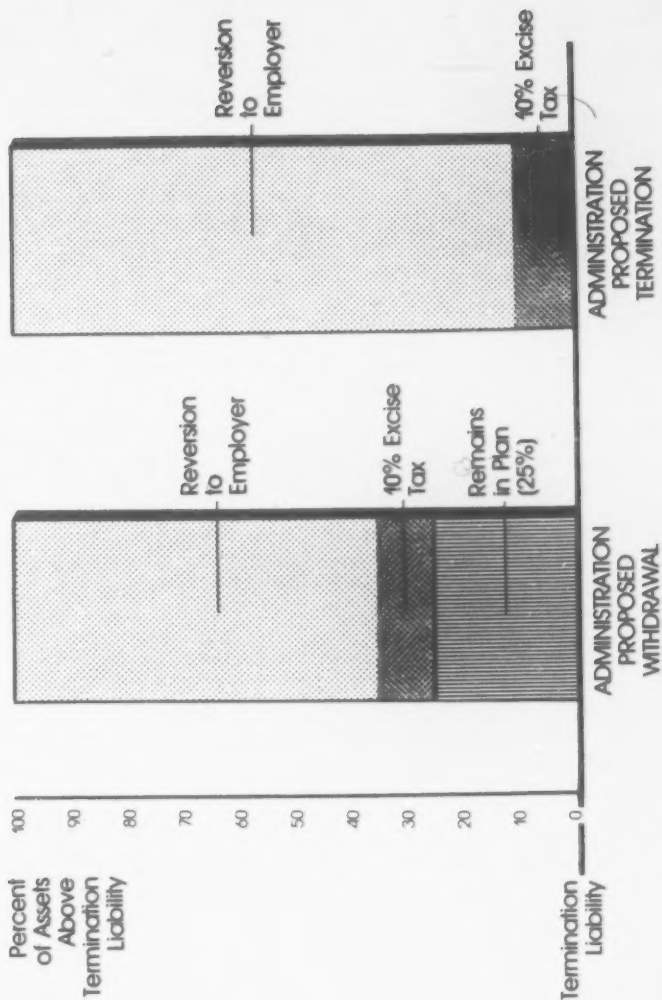
AARP again commends the Administration for its comprehensive approach to the problems of overfunding and underfunding. The Association maintains, however, that the Proposal fails to sufficiently recognize that part of the assets above termination liability belong to plan participants. Because of this, the Proposal does not require an adequate cushion upon withdrawal, and fails to require a pay-out of assets upon termination. In any event, both withdrawals and terminations should be discouraged, with the strongest disincentives always attached to terminations.

Although a number of the minimum funding standards have been improved, AARP is concerned the proposed solution may be unnecessarily burdensome in some situations. Since details are still undeveloped, the Association simply cautions against overburdening an entire system to correct a more isolated problem.

AARP looks forward to continued work with both the Administration and these subcommittees to formulate a legislative solution. The problems have been identified and been given serious consideration by the Administration's Proposal. AARP believes that a more acceptable solution can be devised by building further upon the framework of this Proposal.

Chart 1.

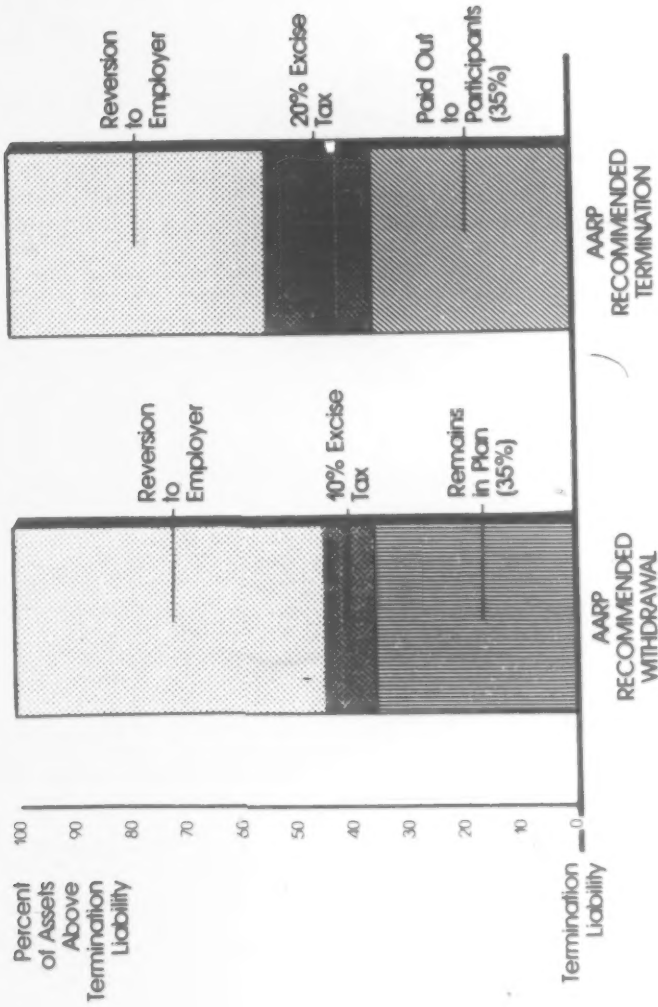
DISTRIBUTION OF PLAN ASSETS Above Termination Liability *



* Assumes plan assets at 200% of termination liability and no underfunded plans in group.

Chart 2.

DISTRIBUTION OF PLAN ASSETS Above Termination Liability *



* Assumes plan assets at 200% of termination liability and no underfunded plans in group.

December 1986

#8602

THE IMPACT OF
'OVERFUNDED'
PENSION TERMINATIONS
ON WORKERS

by

Thomas D. Leavitt

Research Associate, Brandeis University

Research Summary

The Public Policy Institute was formed in 1985 as part of the Division of Legislation, Research and Public Policy of the American Association of Retired Persons. One of the missions of the Institute is to foster research and analysis on public policy issues of interest to older Americans. This paper presents part of that effort.

The views expressed herein are for information, debate and discussion, and do not necessarily represent formal policies of the Association.

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The Impact of 'Overfunded' Pension Terminations on Workers

In recent years there has been a rapid increase in the voluntary termination of "overfunded" defined benefit pension plans by plan sponsors. As of October 1986 over 1300 overfunded plans with over 1.5 million participants have been terminated or have requested approval for termination. The combined assets of these plans were over \$33 billion, of which approximately \$15 billion (46%) had been identified as "excess assets." It is estimated that about 4% of pension covered workers throughout the United States have been affected.

An overfunded pension plan is one where available funds are more than sufficient to meet liabilities accrued up to the point of termination (in contrast to projected future liabilities). When such plans are terminated, plan sponsors are required to purchase annuities to satisfy the liabilities that have accrued but may then "recapture" any excess assets that remain. These terminations are known as asset reversions.

Such terminations have been the subject of considerable controversy. The subject has been debated in several Congressional hearings, in testimony to a special asset reversion task force set up under the Labor Department's ERISA Advisory Council, in trade journals, and in the popular press. One outcome of the debate, instituted in the Tax Reform Act of 1986, has been the imposition of a 10% excise tax on amounts recaptured in terminations after December 31, 1985. Other changes to federal laws and regulations governing these terminations are currently being considered.

This research summary reports on the findings of a comprehensive study of asset reversion done for the American Association of Retired Persons by the Policy Center on Aging at Brandeis University.* The larger report from which this paper is drawn explains the concepts associated with overfunded terminations, summarizes the broad spectrum of opinion that has been voiced, and presents a profile of the terminations that have occurred. In addition, the study reports on a telephone survey of terminated plan sponsors and presents findings from a computer analysis of the potential benefit losses that can result from the termination of pension plans.

Source of Surpluses

As stated above, overfunded pension plans are those in which funds on hand exceed those needed to satisfy liabilities accrued at termination. This does not necessarily imply that an overfunded plan has excess assets on a continuing basis, since plan sponsors usually fund to take account of future inflation and salary increases that will have an impact on benefits. Thus, a primary source of recovery of excess assets is the act of plan termination itself.

* *Overfunded Pension Plan Terminations*. Waltham, MA: Policy Center on Aging, Heller School, 1986. For a copy of this report, contact the AARP Public Policy Institute, publication #86-03.

Historically, another main factor creating excess assets, was the exceptionally high interest rates and massive stock market increases in recent years; investment returns generally exceeded the conservative assumptions used to fund plans. Also, during the recent period of high interest rates, annuities needed to satisfy termination liabilities were available at very favorable rates. These low cost annuities contributed to the size of fund surpluses.

Types of Terminations

There appear to be many reasons for terminations. One, of course, is the availability of excess funds that can be used for other corporate purposes. On the other hand, terminations have in some cases been non-discretionary, including those involving pension plans in companies going out of business or closing a plant or division. Other reasons given include (a) dissatisfaction with a plan, (b) the desire to change from a defined benefit to a defined contribution plan, and (c) the attempt to reduce a company's attractiveness to corporate raiders (because of the excess pension assets).

Overfunded terminations have been grouped into four main categories:

1. Terminations with no replacement plan;
2. Terminations with replacement by a defined contribution plan;
3. Termination/reestablishments; and
4. Spinoff/terminations.

The first two types are self-explanatory. Termination/reestablishments involve a replacement plan that is similar to or the same as the defined benefit plan that has been terminated. Since the replacement plan generally gives credit for past service under the terminated plan, the effect on benefits is generally minimal. There has been some conjecture, however, that these "lean" pension funds will be unable to support benefit improvements—such as postretirement inflation adjustments—in the future.

In spinoff/terminations, active plan participants continue to be covered by the same plan. Their plan is spun off from the original plan with sufficient assets to satisfy the termination liabilities.

The original plan, which then contains only retired and separated vested participants (as well as all surplus assets), is then terminated. The effects of spinoffs are very similar to those in cases of reestablishment.

Profile of Overfunded Terminations

The trend toward overfunded plan terminations has moved forward rapidly during the decade of the eighties, in terms of both the number of terminations and the number of plan participants affected. In 1980 there were a mere 9 terminations where plan sponsors recaptured a million dollars or more. Since then, the number has risen annually and in some years spectacularly. In 1985 there was a total of 487 approved and pending terminations. During this same period, the annual total of plan participants affected has increased from 22,000 to over 600,000—a nearly 30-fold increase. And the surplus assets recaptured have grown from a little over \$18 million in 1980 to over \$6 billion in 1985!

Analysis of Pension Benefit Guaranty Corporation (PBGC) data indicates that there has been considerable diversity among terminating plans. Some generalizations are possible, however. The number of participants in most terminated plans has been small (56% with less than 500 employees). The amount of excess assets has also been comparatively small in many plans (75% with less than \$5 million). However, the degree of overfunding (on a termination basis) has been substantial; plan sponsors recaptured over 40% of plan assets in more than two-thirds of terminations and over 60% in one-quarter of terminations.

The Telephone Survey

A key gap in the information available on plan terminations is the benefit formulas in terminating and successor defined benefit plans, as well as the employer contribution rates in defined contribution successor plans. An April, 1986 Hay-Huggins study commissioned by the Labor Department was a useful first step in collecting such data. Unfortunately, the data in this study concentrated on larger plans, where changes are less likely to be detrimental to plan participants than in smaller

plans. In addition, there are no representative data in the Hay-Huggins study on the extent to which successor plans use pretermination service in calculating benefits.

To gather further information in this area, the Brandeis University Policy Center on Aging carried out a telephone survey of 150 large and small companies that had terminated overfunded pension plans. Unfortunately, there was a high degree of resistance on the part of plan sponsors to cooperating in the survey, indicating great corporate sensitivity on the issue. Nevertheless, at least two important findings emerged. First, among responding companies with new defined benefit plans (a category that contains approximately one third of overfunded terminations), successor plan formulas were usually the same as or similar to terminated plan formulas. Thus, the survey found little evidence of adverse impact on plan participants in such cases, except to the extent that the comparatively less well funded pension funds that remain may not be able to support future benefit increases for active workers and cost of living adjustments for retirees.

However, the survey indicated that there is significant potential for adverse impact on plan participants where the successor plan is a defined contribution plan. In particular, many defined contribution successor plans were profit sharing plans, which are usually not a source of predictable retirement income benefits.

Effects of Terminations on Workers

Attempts to assess the potential for termination benefit loss have been hampered by a lack of information—given the limitations of the Hay-Huggins, Brandeis, and other data collection efforts to date. Given this lack of data and the potential value of evaluating various termination scenarios, an analysis was carried out by the Policy Center on Aging of the potential for benefit loss in a wide variety of hypothetical situations. The use of hypothetical termination scenarios has two main advantages. First, it provides a wide range of models against which to judge the potential for benefit loss in actual terminations. Also, it permits a detailed analysis of what types of workers—in terms of age and years of service—are most affected by

different types of terminations.

Benefit losses were calculated using a computer simulation model developed specifically for the study. Currently, as suggested above, there is little available evidence to suggest that accrual rates in post-termination defined benefit plans are less generous than in the plans they have replaced. The analysis focused, therefore, most attention on scenarios involving terminated defined benefit plans that are either not replaced or are replaced by a defined contribution plan. In recent years, roughly half of plan terminations were of this type.

The potential benefit loss resulting from terminations with no successor plan was examined for two common types of defined benefit formula, one which bases benefits on career average earnings and the other which bases benefits on the average of the highest five years of earnings. Selected findings are shown in Table 1.

Benefit loss was evaluated for workers in plans terminating in 1985. Assumed 1985 earnings were deflated by historical wage rate changes to simulate prior salary histories. Future salaries were calculated using an assumed 5 percent increase in wages, an increase that closely approximates average wage rate increases over the past two decades. Once the wage rate assumptions are made and the worker's years of service are chosen, the benefit loss as a percentage of the benefit that would have been paid is the same for any earnings level and any benefit accrual rate.

Percentage benefit losses for a younger worker are extremely large. For a 30 year old worker with 10 years of service at the time of termination, losses are 92 percent in a career earnings plan and 96 percent in a final average earnings plan. That is, this worker's vested 10-year pension would be much, much larger if he or she were able to continue working until age 65 under the plan.

The middle aged worker is also subject to significant benefit losses if a terminated plan is not replaced. Even with 20 years of service in a terminated plan, a 45 year old worker in a plan with a career average formula loses 75 percent of the benefit. In a plan with a final average earnings formula, where earnings at the end of a career are given increased weight, the loss would be 81 percent.

For the worker nearing retirement, participation in a terminated plan that is not replaced may have more negative consequences than for a younger worker. If a company liquidates or files for

Table 1
Potential Benefit Change:
Plan Termination with No Successor Plan*

Age at Termination	Years of Service at Termination	Terminated Plan Formula	Benefit Loss (% of age 65 benefit)
30	10	career average	92
30	10	final average**	96
45	20	career average	73
45	20	final average**	81
55	30	career average	46
55	30	final average**	52

* Based on simulation analysis.

** Average of highest 5 years of earnings.

Table 2
Potential Benefit Change:
Defined Contribution Successor Plan*

Terminated Plan Formula	Contribution Rate	Rate of Return On Assets	Age/Service at Termination	Benefit Change at Age 65
1.25% x years of service x final average earnings**	5%	5%	30/10	-59%
1.25% x years of service x final average earnings**	7%	9%	30/10	+8%
1.5% x years of service x career average earnings	7%	9%	60/30	-11%
1.5% x years of service x final average earnings**	5%	5%	60/30	-25%

* Based on simulation analysis.

** Average of highest 5 years of earnings.

bankruptcy and releases an older worker, the likelihood of becoming pension covered in another job is small—especially one with pension coverage. In view of this, the benefit losses for workers who have spent entire careers at a company terminating its plan are noteworthy. For the age 55 worker with 30 years of service who expects to work until age 65, a plan termination reduces expected years of service by 10 years or one quarter of the expected total. This one quarter reduction results in benefit losses of 46 percent (career average earnings plan) and 52 percent (final average earnings plan). Similarly, for an age 60 worker with 30 years of service, the years of plan coverage are shortened by 14 percent. The potential losses from this reduction are 27 percent (career average earnings plan) and 31 percent (final average earnings plan).

Even if a terminated plan participant immediately begins work for another company that has a plan with the same benefit formula, benefit losses are significant. The age 55 worker, for example, loses approximately one quarter of the benefit he would have received if the original plan had continued.

To assess benefit losses or gains from defined benefit to defined contribution termination scenarios, the study examined the effects under a wide variety of interest rate and contribution rate assumptions. Selected benefit changes are shown in Table 2. One of the clearest findings is that defined contribution plans are most advantageous to workers who are young at the time of terminations, particularly when investment returns on contributed funds are high. Looking at various scenarios, benefit gains occur only for those workers more than 20 years away from retirement and then only when very high investment returns are assumed. It is for these younger workers that the compounding effect of investment returns in defined contribution plans becomes so important.

Conversely, defined contribution successor plans are particularly damaging to those nearing retirement age at the time of a termination. In this case, contributions have only a short period to compound. Even under very generous assumptions, such workers experience a loss when moving to a defined contribution plan. For example, consider a worker who is age 60 with 30 years of service at the time of termination who (a) moves from a 1.5 percent of career average earnings plan, (b) to a 7 percent of earnings defined contribution plan, (c)

which is projected to earn 9 percent per year interest. If this individual stays in the defined contribution plan until age 65, he would receive a combined benefit from the two plans that is 11 percent less than the benefit that would have accrued if the terminated plan had continued.

The effect on older workers is exaggerated if the terminated defined benefit plan calculates benefits based on final average earnings. Final average earnings formulas act as a preretirement inflation hedge. The value of a high five-year earnings measure, assuming a worker's earnings increase by 5 percent per year until retirement, increases 28 percent in the years between age 60 and age 65 and 63 percent in the years between age 55 and age 65. In addition, there is an effect from the increased years of service in the plan. For example, a person with 30 years of service at age 55 who plans to work until age 65 would have had an additional 10 years of service if the terminated plan had continued. This represents a 33 percent increase in the years of service measure. The 5 additional years of service for the age 60 worker represent a 17 percent increase in the years of service measure.

Combining the final average earnings and additional years of service effects, the age 60 worker who has 30 years of service at plan termination loses out on a 50 percent increase in benefits in the 5 years before age 65. The age 55 worker foregoes a 117 percent increase in pension benefits in 10 years. It is practically impossible for a defined contribution plan to make up these losses.

Issues

A wide range of opinion exists on overfunded terminations. Supporters have argued that the right to terminate is an important aspect of the voluntary private pension system. Without this right, the incentive to establish and adequately fund defined benefit plans would be diminished. They argue, therefore, that attempts to limit terminations actually endanger employees' retirement income security.

Defenders also contend that, for the most part, participants in terminated plans continue to be pension covered, often by plans that offer benefits equal or similar to those in terminated plans. The cases where coverage does not continue usually in-

volve non-discretionary terminations in companies either going out of business or closing a plant or division. Given the continued coverage of most plan participants, they see no major reason why plan sponsors should not recover excess assets. Moreover, they believe the risk that plan sponsors undertake in order to provide specified benefit levels should be balanced by the ability to recoup surplus assets if fund performance is better than expected. If other mechanisms to recapture assets were available, termination would be much less frequently used. In their absence, however, it is argued that the ability to terminate should be retained.

Critics have disagreed with every one of these contentions. They argue that excess assets belong to plan participants rather than plan sponsors, since the contributions used to fund benefits are deferred wages. Moreover, terminations have actually reduced the benefit promise for many participants in terminated plans, particularly those without a replacement plan and those covered by a defined contribution replacement plan. Since such participants will not receive the benefits they contributed towards (through deferred wages), it is argued that they deserve a return of the surplus assets needed to fund the higher benefit promise.

Critics also contend that in cases where defined benefit coverage continues, some or all "surplus" assets are not really in excess of plan liabilities. They point out that after a termination, continuing and replacement plans are significantly underfunded on an ongoing basis. This post-termination underfunding suggests that spinoff and reestablishment terminations actually compromise the security of plan participants' benefits. In view of the rapid increase in the number of terminations and the precariousness of post-termination funding levels, they argue that a failure to legislate restrictions to termination laws will result in a significant loss of confidence in the pension system.

Policy Implications

The Brandeis study indicates that although many overfunded terminations to date have not resulted in immediate harm to plan participants, there still remains a significant potential for adverse effects. Some of these negative consequences are obvious, such as the reductions in expected pension in-

come that occur when terminated pension plans are not replaced by other plans. Similarly, benefit losses will likely result from the replacement of terminated defined benefit plans by potentially less generous and less predictable defined contribution plans.

However, the potential for adverse effects also exists in what many observers view as the most benign terminations—that is, where terminated defined benefit plans are replaced by similar plans. On the one hand, there is the possibility that funds "trimmed down" by asset reversions may not be able to support future postretirement benefit improvements to the extent that plan sponsors have previously provided these adjustments. Thus, for example, retirees who are participants in terminated plans may be more susceptible to the adverse effects of inflation. Further, today's lower interest rates and the slower growth in stock market portfolios suggest that funds reduced to termination liability levels may be unable to maintain adequate funding levels in the future, particularly if companies experience economic difficulties. If this occurs, there is a potential for significant new burdens on the Pension Benefit Guaranty Corporation.

What is most clear for future policy development is that the data needed to fully evaluate the effects of terminations are lacking. The Brandeis study points out the need for timely and comprehensive data on terminated pension plans and, equally important, the need for information on the extent and nature of new plans created. In addition, studies on the trends in post-termination funding levels would be useful for future policy discussions.

Chairman PICKLE. Thank you, Mr. Rother.
Now, Mr. Clayman.

**STATEMENT OF JACOB CLAYMAN, PRESIDENT, NATIONAL
COUNCIL OF SENIOR CITIZENS**

Mr. CLAYMAN. Thank you. I have with me today a colleague, Enid Kassner, sitting with me.

Chairman PICKLE. We welcome you.

Mr. CLAYMAN. I would like to thank the chairman for holding today's hearings on overfunded and underfunded pension plans. Both these issues have reached crisis proportions and now threaten the economic security of hundreds of thousands of retirees.

With regard to overfunded pensions, the National Council strongly believes that pension plan assets represent the deferred wages of employees. As such, we fundamentally oppose efforts to make it easier for companies to recover so-called excess assets from pension plans.

When defined benefit plans are terminated, there are often adverse economic consequences for workers and retirees covered by those plans. Furthermore, these trimmed down pension plans may become underfunded and ultimately add further burden to the Pension Benefit Guaranty Corporation.

The National Council agrees with the administration that pension plan terminations should be avoided. But we do not believe their proposal would be effective. The 10-percent excise tax on asset reversion terminations should be doubled to 20 percent, and it would be reasonable to earmark half of such funds to support the PBGC.

Any termination must be accompanied by protection of the future earnings of current workers. While the National Council remains fundamentally opposed in principle to asset reversions, we agree that if withdrawal of surplus assets is allowed, the price should not be plan termination.

But we believe that any corporate recapture of assets, whether through withdrawal or termination, must be accompanied by a cost-of-living provision for retired pension beneficiaries. This adjustment should be in proportion to the amount of the asset reversion.

It is only fair for well-funded plans to help retirees maintain a decent standard of living during their retirement. Without adjustments, the value of a pension is eroded over time, especially now that more people are living well into their eighties.

Retirees fall far behind inflation, finding themselves with less income just when their medical costs are increasing.

Finally, there must be strong safeguards on the size of the cushion remaining in the plan.

On the issue of underfunded plans, it is crucial that the PBGC remain economically viable. The recent rash of bankruptcies has placed an unsupportable burden on the PBGC. The National Council would support an across-the-board premium increase, but we oppose the administration's proposal for a variable-rate premium, which would adversely impact struggling companies and could even force pension terminations or benefit reductions.

We emphatically believe that employers must make adequate provision to ensure the economic stability of their pension plan. Because Congress has recognized the social value of pensions, employers who provide them receive tax advantages. In return, we feel employers must be willing to live up to their obligations to their workers, retirees, and the Federal Government.

Nowhere has corporate irresponsibility been more blatant than in the recent actions which have violated commitments made to retirees. The most visible case has been that of LTV Corp., but they are not the only offenders. I must tell the Chair that we have had hundreds of letters pouring into our office on this issue, many of them from LTV corporation retirees. Many of our members and other retirees have had their lives thrown into turmoil as a result of these broken promises.

These older workers had no way of knowing that their employer would declare bankruptcy, leaving them unprotected. The National Council has received piles of letters, as I have said, from these retirees. Many have tried unsuccessfully to find work, and others are now working at minimum wage jobs. They are desperate. They tell us they have little left for groceries after paying their utilities, and nothing left to pay their property taxes.

They do not understand how a company can be allowed to "hide in bankruptcy" and shirk its responsibilities. As the wife of a steel worker wrote, and I quote here, "If it were not for the retirees, the company would not have enjoyed many years of prosperity."

The National Council believes the Federal Government—I see that "red eye" staring me in both of my red eyes, Mr. Chairman, and I shall now observe the decorum of the Committee and shut up.

Chairman PICKLE. Well, we appreciate your observation, and you have yielded time with even another minute left, but we appreciate it.

Mr. CLAYMAN. Oh, did I have another minute left? Was that just a warning?

Chairman PICKLE. Well, I have already accepted your offer.

Mr. CLAYMAN. All right. I repeat my offer, then.

[The prepared statement follows:]

STATEMENT OF JACOB CLAYMAN, PRESIDENT
NATIONAL COUNCIL OF SENIOR CITIZENS

My name is Jacob Clayman. I am President of the National Council of Senior Citizens (NCSC). I would like to thank Chairman Pickle for holding today's hearing on overfunded and underfunded pension plans. Both these issues have reached crisis proportions and now threaten the economic security of hundreds of thousands of retirees. I will address each of these issues separately.

Overfunded Pensions

NCSC strongly believes that pension plan assets represent the deferred wages of employees. As such, we fundamentally oppose efforts to make it easier for companies to recover so-called "excess" assets from pension plans.

The current situation, in which many defined benefit pension plans are overfunded, is primarily due to recent years of thriving stock market returns and high interest rates. As a result, since 1980, over 1,300 pension plans, representing more than 1.6 million participants, have been or are about to be terminated, yielding profits to companies of nearly \$16 billion.

When defined benefit plans are terminated, there are often adverse economic consequences for workers and retirees covered by those plans. The result is often smaller pensions, replacement with less adequate defined contribution plans and failure to provide any cost-of-living adjustments for retirees. Furthermore, these trimmed down pension plans may suffer with today's lower interest rates and slower stock market growth. In fact, some may become underfunded, and ultimately add further burden to the Pension Benefit Guarantee Corporation (PBGC).

NCSC agrees with the Administration that pension plan terminations should be avoided, but we do not believe their proposal would be effective in deterring terminations.

NCSC believes the ten percent excise tax on asset reversion terminations should be doubled to 20 percent, and think it would be reasonable to earmark half of such funds to support the PBGC.

In addition, any termination must be accompanied by protection of the future earnings of current workers. While NCSC remains fundamentally opposed in principle to asset reversions, we agree that, if withdrawal of surplus assets is allowed, the price should not be termination of a defined benefit plan which only increases the hardships for present and future retirees. But we believe that any corporate recapture of assets, whether through withdrawal or termination, must be accompanied by a cost-of-living provision for retired pension beneficiaries. This adjustment should be in proportion to the amount of the asset reversion.

It is only fair for well-funded plans to help retirees maintain a decent standard of living during their retirement. Without adjustments, the value of a pension is eroded over time, especially now that more persons are living well into their 80s. Retirees fall far behind inflation, finding themselves with less income just when their medical costs are increasing.

Finally, we cannot overemphasize that any withdrawal of pension funds must not be allowed to jeopardize the security of the plan itself. There must be strong safeguards on the size of the cushion remaining in the plan. It would be an unmitigated disaster to turn overfunded plans into underfunded plans while allowing the companies to profit enormously.

Underfunded Plans

It is crucial that the PBGC remain economically viable and able to safeguard promised retirement income. The recent rash of bankruptcies has placed an unsupportable burden on the PBGC. Last year's premium increase to \$8.50 per employee has proved to be an inadequate solution to the present crisis.

NCSC would support an across-the-board premium increase to safeguard the viability of this institution which is vital to the economic security of retirees. We oppose the Administration's proposal for a variable rate premium, which would adversely impact struggling companies and could even force pension terminations or benefit reductions.

-2-

We emphatically believe that employers must make adequate provisions to ensure the economic stability of their pension plans. Because Congress has recognized the social value of pensions, employers who provide them receive tax advantages. In return, we feel employers must be willing to live up to their obligations to their workers, retirees, and the Federal government.

Nowhere has corporate irresponsibility been more blatant than in recent actions which have violated commitments made to retirees. The most visible case has been that of the LTV corporation, but they are not the only offender.

NCSC must speak out on behalf of our members and other similarly-situated retirees whose lives have been thrown into turmoil as a result of these broken promises.

Thousands of older workers have been asked to take early retirement to make room for younger workers and "for the good of the company" for which, in many cases, they had worked 30 or 40 years. In return, these older workers were promised pension supplements to tide them over until age 62 when they can receive Social Security. They were promised, in many cases, health and life insurance benefits as well.

These older workers had no way of knowing that their employer would then turn around and declare bankruptcy, leaving them unprotected. NCSC has received piles of letters from these retirees, and again and again they have asked, "When will action be taken on legislation protecting retirees' benefits?" They are asking for help. They are afraid of losing their homes. They do not want welfare, they just want the benefits they were promised. But, they are being forced into poverty and feel betrayed by the employer and the country they once believed in.

Many have tried unsuccessfully to find work and say with discouragement, "Who wants to hire someone 58, 60 years old?" Others are working at minimum wage jobs after devoting more than 30 years to one employer.

They are desperate. They tell us they have little left for groceries after paying their utilities and nothing left to pay their property taxes. They do not understand how a company can be allowed to "hide" in bankruptcy and shirk its responsibilities. As the wife of a steelworker wrote, "If it weren't for the retirees, the company would not have enjoyed many years of prosperity."

NCSC believes there must be better safeguards to protect the promises made to retirees. The Federal government must play a role to prevent flagrant violations of the public trust. Corporations must not be allowed to renege on commitments made to retirees. Promised pension supplements must be protected.

At present, neither the employer nor the PBGC guarantees payment of pension supplements which were promised to retirees. In addition, the basic pension benefits covered by the PBGC are adjusted for age, further diminishing the economic security of early retirees.

These persons have been the most tragic victims of the present crisis and they do not comprehend how they have been allowed to lose the benefits they were promised.

NCSC strongly supports the Retiree Benefits Security Act of 1987, which will ensure more equitable treatment of retiree health benefits in the bankruptcy process. But that legislation is merely one step of many that are needed to fully protect the security of retirees.

Long-term solutions must be found to prevent the serious underfunding which has already occurred in some pension plans. But, in addition, immediate action is needed to address the crisis faced by the thousands of retirees who have already lost pension supplements.

NCSC looks forward to working with Congress to find solutions to these issues which are of such vital importance to our nation's retirees.

Chairman PICKLE. We will come back to you gladly.
Now, Ms. Ferguson, if you will proceed.

STATEMENT OF KAREN W. FERGUSON, DIRECTOR, PENSION RIGHTS CENTER, ACCOMPANIED BY KAREN FRIEDMAN, EDUCATION DIRECTOR

Ms. FERGUSON. Thank you, Mr. Chairman.

I am Karen Ferguson, director of the Pension Rights Center. With me is Karen Friedman, the center's education director.

The center is a public interest group that for more than a decade has represented the interests of pension plan participants whose concerns would otherwise not be represented in pension policy deliberations.

Today we are testifying on behalf of groups of retirees from all across the country who have asked us to present to you their views on the administration's proposal on overfunded plans.

These retirees are former employees of some of the Nation's largest companies—Celanese, FMC, Texaco, General Electric, Lear-Siegler, as well as many smaller companies.

The pension funds of many of these retirees have already been depleted. Others have been notified that a termination reversion is imminent, and still others are simply worried that this could happen to them.

These retirees strongly oppose the administration's proposal to allow easy access to excess assets.

The retirees oppose the administration's proposal because it would make it much easier for most companies to take money out of pension plans.

The retirees point out that the administration's proposal totally disregards their interests and ignores the reality of the private pension system. From their perspective, it is "wrong, wrong, wrong."

It is wrong, because their former employers would have no alternative but to give in to demands from their stockholders and creditors to take the money out of the plans. It is wrong because it would encourage imprudent manipulation of pension investments to create surpluses in order to meet short-term corporate needs. Most important, it is wrong because it would end all possibility that the value of the retirees' pensions would ever be restored.

Although administration officials take the position that enough money would be left in the plans for retiree adjustments, in fact, unless such adjustments were made at the expense of promises already made to active workers, they would jeopardize the security of the fund.

What do the retirees propose as an alternative? They propose that there be no withdrawal from either an ongoing or a terminated plan unless and until the plan has restored the value of their pensions. In other words, they are asking that excess plan assets be used to provide them with a permanent adjustment in their lifetime monthly benefits.

Their proposal seems unrealistic—but is it?

Before rejecting this proposal out-of-hand, consider a 78-year-old who retired 16 years ago on a \$100 per month pension. That pension is now worth \$37 per month—almost a two-thirds reduction.

Had this retiree been allowed to cash out his pension when he retired, using interest and mortality rates then in effect, and had he earned the same rate of return as his pension fund over the 16 years, the lifetime monthly benefit he could buy today would be much larger than the amount he is now getting. If you tell him that inflation is down, he will point out that even if he were retiring now, and inflation were at a low 4-percent per year rate, his benefit would be cut in half in 16 years. In short, no matter how low the inflation rate, the older you get, the poorer you are.

Even the best-off of the retirees, those who have gotten occasional cost-of-living adjustments over the years, are having trouble meeting their day-to-day expenses. The fact is that pension plans that do not provide adjustments to their retirees or provide inadequate adjustments are paying benefits in dollars that are worth much less than when the pensioners retired. Payment of their benefits in cheap, devalued dollars is a bonanza to the plan.

The decline of the value of retirees' pensions is neither necessary nor desirable. It is only the result of a structural deficiency in the private pension system, a deficiency that must be remedied if the private pension system is ever to achieve its tax policy objective of providing rank-and-file pensioners with enough money to adequately supplement their Social Security payments.

Virtually every other pension system in the world, including the Federal Government's own pension system, has a mechanism for indexing pensions.

Congress could address this problem through mandated performance indexing, or the development of Government-backed index bonds. Or, the problem could be solved voluntarily. In fact, before the advent of pension raiding, plans had already started to correct the problem. A 1984 study done for the Department of Labor found that three-fourths of all participants were in plans that had voluntarily increased benefits at least once between 1973 and 1979. One-fourth of the retirees had received increases every year.

Retirees, unlike active workers, have no leverage with their companies. Their only chance for having the value of their pensions restored is if there is extra money just sitting there. Only then is there the possibility that a plan trustee sensitive to retirees' needs may be able to convince a company's board of directors that benefits should be raised to help these retirees meet their ever-increasing expenses.

In our view, the retirees' contention that restoration of the value of their pension be a necessary pre-condition to any withdrawal from an ongoing or a terminated plan is very realistic, and it is the only reasonable approach to solving the problem of overfunded plans.

But what about the administration's contention that if companies are not allowed to withdraw money from pension funds, they will terminate or underfund their plans? A company may want to terminate a plan for many reasons, but not because it is unable to withdraw money.

Companies do not maintain defined benefit plans so they can withdraw money when stock market performance is better than expected. They continue defined benefit plans because, unlike defined contribution plans, they can provide a benefit based on final pay and on all of an employee's years of service, and because they can be structured to favor higher paid older employees. The extremely remote possibility that the plans' conservative actuarial assumptions may some day require additional contributions is a small price to pay for a benefit that for most corporate owners and officers, will be the bedrock of their retirement security.

There is also no evidence whatsoever that any company would deliberately underfund a plan solely because it could not freely withdraw assets. If this should ever prove to be the case, the remedy would not be to allow easy access, but to limit the use of actuarial methods that result in underfunding.

We have limited our comments to the administration's proposal on overfunded plans, but would be pleased to answer any questions you may have about our views on the administration's other proposals.

Thank you.

[The prepared statement follows:]

PENSION RIGHTS CENTER

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STATEMENT OF THE PENSION RIGHTS CENTER
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
APRIL 7, 1987

Mr. Chairman, Members of the Subcommittee. I am Karen Ferguson, Director of the Pension Rights Center, with me is Karen Friedman, the Center's Education Director.

The Center is a public interest group that for more than a decade has represented the interests of plan participants whose concerns would otherwise not be represented in pension policy deliberations.

Over the years we have testified before this Subcommittee on behalf of

- * workers who would have been adversely affected by proposed cutbacks in the Employee Retirement Income Security Act of 1974;
- * retirees whose benefits were in danger of being reduced by the Multiemployer Pension Plan Amendments Act of 1980;
- * women office workers seeking the important protections provided by the Tax Equity and Fiscal Responsibility Act of 1982;
- * widows and divorced women who now are benefitting from the Retirement Equity Act of 1984; and most recently
- * the millions of workers who will benefit from the pension equity provisions included in the Tax Reform Act of 1986.

Each time, you responded to the concerns of the participants we represented.

Today we are testifying on behalf of groups of retirees from all across the country who have asked us to present to you their views on the Administration's proposal on overfunded plans. These retirees, from Lubbock, Texas, Christiana, Delaware, Prospect, Kentucky, Cornelius, North Carolina, Trenton, New Jersey, Grand Rapids, Michigan, Churchill, Virginia, Schenectady, New York, and Conroe, Texas, are former employees of some of the nation's largest corporations--Celanese, Texaco, General Electric, Lear Siegler, Mobil and FMC, as well as many smaller companies.

The pension funds of many of these retirees have already been depleted. Others are have been notified that a "termination-reversion" is imminent. And still others are simply worried that this could happen to their plans.

These retirees strongly oppose the Administration's proposal to allow easy access to "excess" assets. Our statement today explains the reasons for their opposition and offers an alternative proposal.

The retirees oppose the Administration's proposal because it would make it much easier for most companies to take money out of overfunded pension plans. No longer would

companies have to notify participants of their intention to withdraw pension money--and listen to their angry and bewildered protests. They would not have to file documents with government agencies, and they could withdraw the money even if there were no provision in the plan authorizing withdrawal. They also would no longer have any cause to consult their consciences about the morality of their actions.

The trade off for this easy access would be that the companies could withdraw slightly less than is permitted under current rules. In a typical plan, the company would have to leave in the plan an amount to cover all benefits earned up to the withdrawal date, plus an additional amount to assure that the plan would not be underfunded the day after the withdrawal.

-This proposal is on a fast track toward a business-labor consensus. All that is needed is for the Administration to accede to demands that it give up its control group concept for overfunded plans and provide a deterrent to termination in the form of a one-time participant payout on termination.

At first glance a consensus of this sort would appear to have something for everyone--and even the potential for up to \$20 billion in additional revenue for the Treasury--until you talk to the retirees we are representing here today.

As they point out, such a proposal totally disregards their interests and ignores the reality of the private pension system. From their perspective it is "wrong, wrong, wrong."

It is wrong because their former employers would have no alternative but to give in to demands from their stockholders and creditors to take money out the plans.

It is wrong because it would encourage imprudent manipulation of pension investments to create surpluses to meet short-term corporate needs.

Most important, it is wrong because it would end all possibility that the value of the retirees' pensions would ever be restored.

Although Administration officials take the position that enough money would be left in the plans for retiree adjustments, in fact, unless such adjustments were made at the expense of promises already made to active workers, they would jeopardize the security of the fund.

What do the retirees propose as an alternative? They propose that there be no withdrawal from either an ongoing or a terminated plan unless and until the plan has restored the value of their pensions. In other words, they are asking that "excess" plan assets be used to provide them with a permanent adjustment in their lifetime monthly benefits.

In the context of compromise, their proposal seems "unrealistic." But is it?

Before rejecting the proposal out of hand, consider a 78 year old who retired 16 years ago on a \$100 a month pension. That pension is now worth only \$37, almost two-thirds less. Yet this man had worked a lifetime for one company, counting on a pension that would allow him to meet his expenses.

Had this retiree been allowed to cash out his pension when he retired, using interest and mortality rates then in effect, and had he earned the the same rate of return as his pension fund earned over the 16 years, the lifetime monthly benefit he could buy today would be much larger than the

amount he is now getting.

If you tell him that inflation is down, he'll point out that even if he were retiring now, and inflation were at a low 4% a year rate, his benefit would be cut in half in 16 years. In short, no matter how low the inflation rate, the older you get, the poorer you are.

Even the "best off" of the retirees, those who have gotten occasional cost of living adjustments over the years are having trouble meeting their day-to-day expenses.

The fact is that pension plans that do not provide adjustments to their retirees, or provide inadequate adjustments, are paying benefits in dollars that are worth much less than when the pensioners retired. Payment of their benefits in cheap, devalued dollars is a bonanza to the plan.

The decline of the value of retirees' pensions is neither necessary nor desirable. It is only the result of a structural deficiency in the private pension system, a deficiency that must be remedied if the private pension system is ever to achieve its tax policy objective of providing rank and file pensioners with enough income to adequately supplement their social security payments.

Virtually every other pension system in the world, including the federal government's pension system, has a mechanism for indexing pensions.

Congress could address this problem through mandated performance indexing or the development of government backed indexed bonds.

Or it could be solved voluntarily. In fact, before the advent of "pension raiding," most larger plans had already started to correct the problem.

A 1984 study done for the Department of Labor found that three-fourths of all participants were in plans that had voluntarily increased benefits at least once between 1973 and 1979. One-fourth of the retirees had received increases every year.

(A more recent study, the Bureau of Labor Statistics survey of pension plans in medium and large companies, reports that in 1985 fewer than half - 41% - of participants were in plans that gave occasional adjustments to retirees.)

Retirees, unlike active workers, have no leverage with their companies. Their only chance for having the value of their pension restored is if there is "extra" money "just sitting there." Only then is there the possibility that a plan trustee sensitive to retirees' needs may be able to convince a company's board of directors that benefits should be raised to help them meet their ever increasing expenses.

In our view, the retirees contention that the restoration of the value of their pension benefits should be a precondition of any withdrawal from either an ongoing or a terminated plan is very realistic, and the only reasonable approach to solving the problem of overfunded plans.

But what about the Administration's argument that if companies are not allowed to withdraw money from pension funds, they will terminate or underfund their plans.

A company may want to terminate a plan for many reasons, but not because it is unable to withdraw money. The practice of pulling money out of pension plans for corporate purposes is a very new idea--less than seven years old. For 42 years, from 1938 until 1980 employers could have

terminated their plans in order to "access excess assets" but they did not do so.

What companies did in the past, and should continue to do today, is reduce contributions when a plan is overfunded. That is sound tax and sound pension policy.

Companies do not maintain defined benefit plans so that they can withdraw money when stock market performance is better than expected. They continue defined benefit plans because, unlike defined contribution plans, these plans can provide a benefit based on final pay, and on all of an employee's years of service, and because they can be structured to favor higher-paid, older employees. The extremely remote possibility that the plan's conservative actuarial assumptions may some day require additional contributions is a small price to pay for a benefit that, for most corporate owners and officers, will be the bedrock of their retirement security.

There is also no evidence whatsoever that any company would deliberately underfund a plan solely because it could not freely withdraw assets. If this should ever prove to be the case, the remedy would not be to allow easy access, but to limit the use of those actuarial methods that result in underfunding.

Because of time constraints, we have limited our comments to the Administration's proposal on overfunded plans, but would be pleased to answer any questions you may have about our views on the other Administration proposals.

We thank you for the opportunity to testify today.

THE ADMINISTRATION'S PROPOSAL TO MAKE IT EASIER
FOR COMPANIES TO PULL MONEY OUT OF PENSION FUNDS

WHAT THE ADMINISTRATION'S PROPOSAL WOULD DO

The proposal would allow companies that have only one pension plan to pull money out of a pension fund as long as enough money is left to pay all of the pension benefits that were earned on the date of the withdrawal to

- (1) people who have left the plan after having earned the right to receive a benefits at retirement age. This includes all retirees and "vested" workers who have left the plan but have not yet retired.
- (2) people working under the plan who have earned the right to receive a pension at retirement age, "vested" workers.
- (3) an additional amount would have to be left in the plan for those workers who are expected to work under the plan until retirement age. Under many plans, the pension earned by those workers on the date money is withdrawn from the plan will be figured using the the worker's final wages or salary. The proposal requires a plan to leave this additional amount in the plan unless the plan buys annuities from a life insurance company to pay workers and retirees' pensions.

Plans that do not calculate benefits using a final pay formula must leave in the plan an amount equal to 25% of the amounts owed on the withdrawal date to the plan's "vested" workers and retirees.

If a plan buys annuities for workers and retirees, it only has to leave in the fund 40% of what it expects will be owed as the result of future increases in wages or salaries or 10% of the amounts owed vested workers and retirees if this is larger.

No money has to be left in the plan for people who have not worked long enough under the plan to earn the right to receive a pension, whether or not the plan expects them to "vest" in their benefits in the future.

The proposal provides that companies can pull money out of the plans in 3 installments over a 10 year period, or all at once every 10 years.

If a company stops a pension plan, the plan must buy annuities for all workers and retirees, including workers who have not worked long enough to "vest" under the plan. The plan is required to pay benefits that are based on earnings as of the date the plan stops. All other money in the plan can be paid to the company. The company cannot, however, set up another similar plan for 5 years.

Where a company has more than one pension plan, it will only be able to pull money out of an ongoing plan if there is enough money in all the plans to cover everything owed to vested workers and retirees on the date of withdrawal. There is no requirement that money be transferred from one plan to another as long as the plans continue.

If a plan terminates, and the company has underfunded plans, there must be a transfer of money to the underfunded plans before the company can pull money out of the overfunded plan.

A 10% excise tax imposed by the Tax Reform Act of 1986 on most withdrawals would be waived if the "surplus" assets were used to fund health benefits for current retirees.

WITHDRAWAL OF PENSION MONEY UNDER CURRENT RULES

Federal private pension and tax laws now say that all money that a company puts into a pension fund and all money earned by the fund is held in trust for workers and retirees and is to be used exclusively for their benefit. The only way that a company can legally withdraw the money in the pension fund is if it first stops - or "revokes" - the trust. Even then it can only get access to the money in the trust fund if all benefits owed by the plan are paid and if the plan includes specific language saying that the company can take back whatever is left in the fund. Many plans currently do not provide for money to go to the company when a plan is ended. In these plans any "surplus" money must be paid to workers and retirees.

Since May 1984 the Administration has permitted what are called "Guideline" terminations of pension plans. If a company follows certain government approved guidelines, it can keep its pension plan going and still pull money out of the plan. Most commonly companies do this by putting all the money owed to retirees and vested workers, and all "surplus" money, into a new pension plan and then ending the new plan. The old plan continues for active workers. It is unchanged except for the fact that it has only enough money to pay the benefits that have been earned by the active workers.

The guidelines provide that all active workers receive benefits under the plan, including those that have not worked long enough to "vest" under the terms of the plan. They also require that life insurance company annuities be bought for all workers and retirees.

A company can withdraw money through a guidelines termination only once every 15 years and only if there is a provision in the pension plan stating that "surplus" assets are payable to the company.

PENSION RIGHTS CENTER

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For release March 23, 1986

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PENSIONERS PROTEST "LICENSE TO LOOT"

Retirees from three major corporations fired off an angry letter today to Secretary of Labor William E. Brock protesting the Administration's new pension proposal.

The pensioners, who testified last year before a Labor Department task force, charge that the Administration has disregarded their views and forged ahead with a proposal that is "nothing but an unrestricted license for employers to loot pensioners' money."

The letter points out that pension plans are set up for workers and retirees and it is only through a loophole in the pension law that companies have been able to pillage plans.

They strongly criticize the Administration for making it "even easier than under present law for companies to pull money out of plans."

The letter points out that while pension plans have been making a killing in the stock market, retirees' pensions decline every year.

"Even minimal inflation -say 4%- will quickly decimate the real value of a pension, cutting it in half in a mere 15

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years."

The retirees appeal to Secretary Brock to reconsider the needs of retirees when he testifies tomorrow before the Joint congressional hearing held by the Senate Labor Subcommittee and the House Subcommittee on Labor-Management Relations. The hearing will be at 9:00 a.m. in Dirksen 430. They say that as it is now the Administration favors "employers over retirees, profits over people."

The pensioners, from Celanese, FMC and Raymond International, suggest that the Administration give retirees a fair share of the surpluses that were created, in part, by the investment of their money.

March 23, 1987

The Honorable William E. Brock III
Secretary of Labor
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, D.C. 20210

Dear Secretary Brock:

We are writing to protest the Administration's total disregard of the interests of retirees in its proposal to permit companies to withdraw "surplus" money from ongoing pension plans. The proposal is nothing but an unrestricted license for employers to loot pensioners' money.

On March 14, 1986, we were invited to testify before the Department of Labor's ERISA Advisory Council. We told the Council how our companies - Celanese, Raymond International and FMC - had taken millions of dollars out of our pension funds for leveraged buy-outs, takeovers, and other selfish corporate purposes without consideration for the welfare of the retirees for whom the funds had been established.

We assumed that we were asked to present our views because the Administration was sincerely interested in what we had to say. But it's all too clear that our testimony had no effect.

The Administration's proposal puts short-sighted employer interests ahead of the needs of retirees. It would make it even easier than under present law for companies to pull money out of plans. This is a giant step backwards and makes no sense.

Retirees accept lower salaries during their working lives on the assumption that they are "buying" pensions that will make it possible for them to meet their expenses in retirement.

But without upward adjustments in our pensions their purchasing power rapidly declines. Even minimal inflation - say, 4% - will quickly decimate the real value of a pension, cutting it in half in a mere 15 years. Double the inflation and the pension will become virtually worthless in less than a decade.

In the past, retirees have had to depend on voluntary increases to help mitigate the worst effects of inflation. When plans did better than expected, and there were "surpluses" in the fund, many larger plans gave adjustments as a matter of policy. These didn't bring pensions up to their true value, but they certainly helped. In the cases of FMC and Celanese, we'd come to count on these adjustments.

Now the Administration is proposing to end the positive trend of voluntary adjustments. Even if companies want to provide adjustments to their retirees they will not be able to do so in the face of demands from their stockholders that pension surpluses be used for short-term profit.

This is not and never was the purpose of the pension system. The law is clear as day. It says unequivocally that pension money must be used solely for workers and retirees. It is only through a technicality - a loophole in the law discovered only seven years ago - that our companies were able to pillage our plans. It is a sad comment on this Administration's priorities that instead of closing this loophole and rectifying the problem, it has chosen to favor employers over retirees, profits over people.

We ask that before you testify on this issue tomorrow, you read the statements we presented to the Advisory Council. We believe that the Administration has a unique opportunity to help retirees protect the value of their pensions by recommending that they be given a fair share of the surpluses that were created, in part, by the investment of their money.

Although it may be too late for us, it is not too late for many millions of other older Americans who are sure to lose faith in a system if it can only buy them pensions worth less and less each year.

Sincerely yours,

Percy A. Penley

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Jean Bush

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Chairman PICKLE. I appreciate the panel's comments. You have certainly added a different approach to our consideration, and I am sure we will study your testimony carefully.

Do you take a position in general that we do not need to raise the premiums now, or do you take any position on that point specifically? Do you think a premium increase probably is justified at this point, either a flat or a variable?

Mr. CLAYMAN. Are you addressing all of us?

Chairman PICKLE. Either one of you. Mr. Clayman, I will recognize you first, since we reserved you 1 minute a while ago.

Mr. CLAYMAN. Yes, we would recommend that, because the problem is severe. We feel that we have a finger on the pulse of the elderly, at least, who are retired. We hear from them vehemently. And they would want that. It is likely to be a small safety valve, a small buttress, fortress, but it should be put there, because the problem is enormous as we see it, and we need more protective dikes built than we now have.

Chairman PICKLE. Do any of you think we should not have any withdrawal of assets from these overfunded programs?

Ms. FERGUSON. Yes, basically, we do. Before 1980, of course, no one withdrew money from overfunded plans. What you did was you simply reduced contributions, and you improved benefits, and that was the way the game was played for 42 years. Pension plans have been irrevocable trusts since 1938, and nobody took advantage of it, and the system worked.

Chairman PICKLE. You do not, then, favor any kind of a cushion or even a higher cushion than the administration proposed.

Ms. FERGUSON. That is a very indirect way of solving a problem that we think should be addressed directly. And the critical problem is, from our perspective, the absence of adjustments for retirees.

Chairman PICKLE. Well, you did testify, as I recall, Ms. Ferguson, that you said we would have no withdrawal unless the plan participants were notified of the intention to withdraw and, I presume, vote on it or make comments on it. How would you do that—have a vote of the—

Ms. FERGUSON. Well, actually, that part of the statement refers to current law, which does require notice; it requires an amendment, or provision, in the plan, and the administration's proposal would eliminate that.

Chairman PICKLE. I thought you were saying we should not have any kind of a withdrawal, unless the participants had a chance to vote on it or comment on it.

Ms. FERGUSON. Our proposal was that there should be no withdrawal unless the retirees' pensions were fully adjusted to restore their real value as of the retirees' retirement date.

Mr. THOMAS. Would the Chairman yield on that point?

Chairman PICKLE. Mr. Thomas.

Mr. THOMAS. Ms. Ferguson, it is easy to say no withdrawals unless there is a restitution. Would you propose some kind of a standard be utilized, either CPI or something that would be structured? Or could there be an attempt to negotiate between the corporation and the retirees on partial restoration? My guess would be that something would be better than nothing.

Ms. FERGUSON. I would leave that to the plan fiduciary. One of the things that has happened in recent years is that the role of the plan fiduciary as guardian of the participants' interests is being eroded. And I think that a plan fiduciary could make the assessment of what the real value is. There are many methods of doing that.

Mr. THOMAS. Well then, in addition, don't you think that especially those plans that were structured by collective-bargaining agreements, that that should have been something which was negotiated at the time the pension was structured or was this an oversight on the part of those who negotiated?

Ms. FERGUSON. Well, ordinarily, unions cannot bargain for retirees, people already retired.

Mr. THOMAS. Well, at the time they were employees.

Ms. FERGUSON. The reality is that the immediate concern in the collective-bargaining situation is for current income, current benefits, and—

Mr. THOMAS. Many of these plans were negotiated under collective-bargaining agreements in terms of the pension plans. Obviously, a deficit in the negotiating process was that they did not guarantee some kind of a restitution of purchasing power upon a given date that would have been required by the plan.

Ms. FERGUSON. That is right. Many of the major unions do provide some adjustments, or try to, at each collective bargaining—

Mr. CLAYMAN. If I may interject an observation, I think that approach, which the question implies, is rather too legalistic.

I was around when the pension plans came into effect, and I remember some of the bargaining situations then in the forties, early forties and the late thirties even, and then, in those days, the steel industry, for example, that broke the dam, United States Steel, with a pension agreement with the Steel Workers Union, they had a certain amount of money that they felt they could give to their workers. And in essence, the union was asked, "What do you want? Do you want it in wages, or do you want it in some other form?"

And the union said it wanted it in other forms as well as wages. And so if there had been no agreement then on a pension plan, it would have been higher wages for the workers, which means, if you accept this thesis at all, that terminations should not be permitted, and the reversion of money should not be permitted, because it simply was another form of wages. And that is why the unions now, whether by contract or otherwise, whether you had lawyers who understood and put the kind of protective language in, it does not change the moral picture or the ethical picture or the historical picture.

Mr. THOMAS. It does, however, indicate that there were agreements between the workers and the employers, and apparently not included in that agreement was an attempt to maintain a cost-of-living standard in the pension. Now there is a request that Government, after the fact, provide something that was not provided in the agreement between the workers and the corporation, that is a restitution of the pension amount. Some folks would argue that that is not an appropriate role for us to play if the workers themselves did not enter into that agreement with the employer. It may

be hindsight, but there are many plans now that attempt to incorporate an inflation factor.

The question would be, is it proper for Government then to modify the agreement between the worker and the employer after the fact. That is one of the things we would have to focus on.

I thank the chairman for allowing me to interrupt.

Chairman PICKLE. Mr. Thomas, I appreciate your asking that question, and that is what I was driving at when I asked Ms. Ferguson earlier if she would notify all the plan participants and let them vote on it. What you were saying is they should not be terminated, or the excess withdrawn, until they had the value of the pensions fully restored. Well, that in effect would be giving them the cost-of-living, as Mr. Thomas says, and that would be doing it after you had already made your agreement.

Ms. FERGUSON. But only when you knew there was money there to do it. The difficulty of negotiating ahead of time for a cost-of-living adjustment—the real reason we do not have automatic cost-of-living adjustments—is because it is difficult to anticipate ahead of time. It is a very scary thing for an employer or an employer and a union to predict ahead, to commit themselves to that kind of long-term goal.

But here we have a unique situation where, because of better than expected, much better than expected, stock market return, you do have a situation where the deficiencies of some plans can be remedied. And what we are really saying is that in those plans, where arguably the employees may have given up a greater portion of their wages, which is why the plans were well-funded and now overfunded, that it is appropriate to, in this small way, remedy this very big deficiency of this trillion-dollar system.

Chairman PICKLE. Do any of you think that we should not have the right to withdraw excess assets in the pension fund, that the company should not be able to withdraw any funds out of it? Do any of you say that they should not be able to?

Mr. CLAYMAN. That is my personal view, and I think that is the trade union view, too. And we have indicated that in our testimony. But we have also recognized some of the realities of legislation, and we have suggested some alternatives. And they could be strong alternatives. One of them means that we should provide a cost-of-living increase. Another is a suggestion made that if they recapture money, then 20 percent of it ought to go to the agency that guarantees the program.

There are other variations.

Mr. ROTHER. Mr. Chairman, if I could tackle that one, I think there are two situations very pragmatically where we might agree to the fact that withdrawals in some cases can be beneficial. One is where a withdrawal allows an enterprise to continue rather than to face bankruptcy, and another is our concern about the incentives to employers to establish new plans. After all, we still have the majority of people in this country not vested in a pension plan, and we need to extend that further. And we would be concerned, if we were too rigid, that we might scare people away from establishing a voluntary pension plan.

But nonetheless, I would like to say that once you do have a plan established, and you have necessary assets built up beyond that

computed on a termination basis, we do think you need a greater set-aside for future contingencies for the benefit of retirees than that contained in the administration's proposal.

Mr. THOMAS. Would the chairman yield on that point?

Chairman PICKLE. Mr. Rother, in your proposal, you obviously, at least it appears that you are not in agreement with Ms. Ferguson. You have provided a concern about the margins as to who gets what, and you want a restructuring of the margins in terms of termination. And in transferring to other plans, you have a hierarchy of what ought to be done with them, and your first hierarchy is the security of the participants of the original pension plan. And by original, my assumption is that you then do not include a cost-of-living provision in the original plan—or, do you?

Mr. ROTHER. No, not in a withdrawal. We believe that the security of the original plan participants is a liability to the plan that needs to be calculated on an ongoing basis. And the administration's proposal calculates that on a termination basis. So that we disagree on how to calculate that risk.

But your overall point is a correct one, in that we are not now advocating that there should be a permanent cost-of-living lock-in. I think, however, under some other circumstances, we would advocate that. But given the conditions we have today, I do not think that is realistic.

Mr. THOMAS. Mr. Clayman, have you had a chance to look at the AARP proposal to increase the cushion percentage from 25 to 35 percent? You say you are philosophically opposed to it, but would you support their revised percentage as a more appropriate figure than the administration's, if there is going to be a change?

Mr. CLAYMAN. I have not seen the AARP proposal as yet, but as you explain it, I reiterate my first notion which is, that there should not be permitted any reversion of assets unless there may be some so obvious situation that it makes practical sense as well as ideological sense. And that would not come very often. But if there is to be some form of reversion permitted in whatever legislation comes from this committee, hopefully, it will build some safeguards, both in protection of the agency that handles these issues and safeguards for the retirees. And I am inclined to believe, just simply on the basis of listening to your explanation of Mr. Rother's notion, that it is one of the safeguards that could make sense.

Mr. THOMAS. He is concerned about the cushion aspect, and he wants 135 percent rather than 125 or an alternative to provide that extra margin.

I am also sensitive to your testimony, Mr. Clayman, about the fact that medical costs of individuals in their later years are of concern to you. They are of concern to all of us, and another subcommittee of this committee is looking at options for a catastrophic medical plan.

Ms. Ferguson, absent your radical approach, which may or may not be adopted, do you agree with AARP in terms of a need for a larger percentage cushion than the 25 percent that is proposed by the administration?

Ms. FERGUSON. That would be a bare minimum. Again, what has happened here is that the administration has shaped the dialog. They have used terms that now everybody is using; everybody is

talking in terms of the size of the cushion, the size of the excise tax. And there is no rational basis for that. It is a possible structure, but it is not the only approach.

Obviously, if you raise the cushion high enough, if you raise the tax high enough, you will achieve exactly the objectives that the retirees we are representing are achieving.

I might point out that there is an interesting anomaly that others may have pointed out earlier today in the administration's proposal. In fact, retirees who are in an overfunded plan in a control group situation where there is an underfunded plan are actually very well-off.

What you have in those situations is a small group of fortunate retirees who will have their benefits increased because their overfunded pension plan is going to have to do something with that money. It is not going to transfer it to a totally unrelated, underfunded plan in a completely different corporation in a completely different part of the country.

The only relationship between the overfunded and underfunded plan is that they have the same stockholders. That has nothing to do with the people whose money it is.

Mr. THOMAS. Your concern is bringing additional people to the table, such as the retirees from some previous agreement, and that they ought to share in the surpluses that were not anticipated.

Ms. FERGUSON. They are simply asking that the surplus be recaptured in order to restore the value of their pension. I would point out that in any other country, and certainly in the halls of this building and any Government agency, if you were to suggest to any individual that his or her pension would be frozen at age 60 or 65, for the next 15 or 20 years, thereby being cut in half, or by two-thirds, it would be a shocking concept. We have accepted this in the private sector; we think it is time to question it.

Mr. THOMAS. You might be also indicating, then, that perhaps the Government at various levels is perhaps a bit more of an enlightened employer than many of the employers in the private sector. Many employees at the time they made retirement plans did not have the foresight to realize what would happen to the earning power of their money. You ask us to step in as a third party and adjust an agreement that has already been made. I just want to dwell on that point, because that is really what you are asking.

Ms. FERGUSON. Well, I might point out that most of the employees we happen to be representing today—Karen Friedman has been going around the country, working with these retiree groups—very few of them actually are represented by unions. These are typically long service people, they have worked an entire lifetime for one company, they tend often to be salaried, and they were not in a position to make a bargain.

I might mention that one of the retirees, a former senior vice president of administration for Raymond International, did try throughout his tenure as senior vice president to convince the board of directors to provide cost-of-living adjustments for retirees because so many of the Raymond International retirees were living at the poverty level. They refused. They used the money for a leveraged buyout, which entrenched the management. You could say

that Mr. Bush should have struck a harder bargain. He was not in a bargaining position despite the fact that he was at the top of the company.

Mr. THOMAS. Thank you, Mr. Chairman.

Chairman PICKLE. Let me ask a question to the panel.

Some people have argued that plan terminations are still too attractive under the administration's proposal. Keeping in mind that this is a voluntary pension system, what additional steps should be taken to make termination less attractive than withdrawals?

You have got a right to withdraw certain assets, still keeping the cushion. But the argument is made, of course, that that really makes it more attractive for terminations. Do you agree with that, or do you have any recommendations as to that?

Mr. ROTHER. Well, Mr. Chairman, we are very concerned about the incentive to terminate as opposed to withdrawal, even recognizing in a voluntary system you have these two choices. We think it should never be more attractive to the employer to terminate rather than withdraw.

The chart, again, that is in the testimony and the one on the top, over on the right, contains our suggested changes to the administration's plan that would achieve that result. And I can just summarize. The cushion would be paid out as benefit enhancements to plan participants upon termination, to both workers and retirees. In addition, you would have a 20-percent excise tax as opposed to the proposed 10-percent tax.

This combination would always, I believe, make terminations less attractive. It would preserve a voluntary pension system, but it would mean you would only have a termination where there were other considerations, not just let us get the most money we can.

Chairman PICKLE. You make a good point.

Well, I appreciate your views. I know what you are saying is that basically the money in these plans belongs to the plan participants. It is their money and not just the company's per se, and that the rights of the participants ought to be protected so that they do not end up without plans or with very reduced plans. You certainly make some good points.

The committee will be submitting questions to you for further response, and if you would care to, we would like to receive your comments, particularly in view of the testimony that has been presented this morning.

Yes, Mr. Rother.

Mr. ROTHER. Mr. Chairman, if I could just have one last comment. I believe there is one proposition we would all agree on, and that is, the current situation under current law is entirely unacceptable. I think we all agree that it is past time that Congress address it, and we support your efforts to do so.

Chairman PICKLE. Well, when you say you are all agreed, you mean your panel.

Mr. ROTHER. Yes.

Chairman PICKLE. I do not know that that would be in agreement with everybody else this morning. But I certainly appreciate your comment, and I appreciate each of your participation today. Our staffs will be working with you as we go forward with further consideration.

Again, I want to say to the committee that we will have a hearing on this same question again on Thursday morning at 9:15 in this room.

So the committee then will stand adjourned until that time.

Thank you very much.

[Whereupon, at 12:35 p.m., the subcommittee was adjourned, to reconvene Thursday, April 9, 1987, at 9:15 a.m.]

ADMINISTRATION'S PENSION PLAN FUNDING AND PREMIUM RATE PROPOSALS

THURSDAY, APRIL 9, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to call, at 9:15 a.m., in room 1100, Longworth House Office Building, Hon. Ronnie Flippo presiding.

[The press release announcing the hearing follows:]

FOR IMMEDIATE RELEASE
MONDAY, MARCH 23, 1987

PRESS RELEASE #6
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1105 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D. C. 20515
TELEPHONE: (202) 225-3627

THE HONORABLE J. J. PICKLE (D., TEXAS), CHAIRMAN,
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ANNOUNCES A HEARING TO RECEIVE PUBLIC COMMENT
ON THE ADMINISTRATION'S PENSION PLAN FUNDING AND PREMIUM RATE PROPOSALS

The Honorable J. J. Pickle, (D., Texas), Chairman of the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, announced today that the Subcommittee will hold hearings to receive testimony from the General Accounting Office (GAO), the Congressional Budget Office (CBO), and public witnesses on pension plan issues. Hearings have been scheduled for Tuesday, April 7, 1987, beginning at 10:30 a.m., and for Thursday, April 9, 1987, beginning at 9:15 a.m. Hearings will be held both days in the main Committee hearing room, 1100 Longworth House Office Building.

The Subcommittee's hearings will focus on analysis and discussion of the Administration's proposals affecting funding and termination of single-employer defined benefit pension plans (as outlined to the Subcommittee on Oversight in a hearing held on March 6, 1987), and the Administration's variable premium rate proposal (to be presented by the Pension Benefit Guaranty Corporation (PBGC) to the Subcommittee on Oversight at 9:15 a.m. on April 7, 1987).

In announcing these hearings, Chairman Pickle made the following statement: "It is critical that the Subcommittee on Oversight receive thorough and complete comments from the public on the Administration's legislative proposals affecting single-employer defined benefit pension plans. These two days of Subcommittee hearings are targeted toward obtaining the views and concerns of those operating within, or benefiting from, our current single-employer pension system.

"I am anxious to learn what employers, employees, and those who have analyzed PBGC's present financial condition consider reasonable reform measures."

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Subcommittee must submit their requests to be heard by telephone to Harriett Lawler [(202) 225-3627] no later than Tuesday, March 31, 1987, to be followed by a formal written request to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D. C. 20515. Requests should indicate the specific issues and points the witness wishes to address, in order to facilitate scheduling. It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Subcommittee to hear as many points of view as possible. The Subcommittee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee [(202) 225-5522)].

In order to assure the most productive use of the limited amount of time available, witnesses scheduled to present oral testimony are requested to briefly summarize their written statements in no more than five minutes. The full statement will be included in the printed record. Further, witnesses scheduled to appear before the Subcommittee are required to submit 150 copies of their prepared statements to the Subcommittee on Oversight office, room 1105 Longworth House Office Building, by close of business Friday, April 3, 1987. Failure to do so may result in the witness being denied the opportunity to testify in person.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Persons submitting a written statement in lieu of a personal appearance should submit six (6) copies of their statement by the close of business Friday, April 24, 1987, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D. C. 20515. If those filing a written statement for the record of the printed hearing wish to have their statement distributed to the press and the interested public at the hearing, they may provide 75 additional copies for this purpose to the Subcommittee office, room 1105 Longworth House Office Building, in advance of the public hearing.

SEE ENCLOSED FORMATTING REQUIREMENTS.

Mr. FLIPPO. The committee will come to order.

We will ask our guests to please take seats. The Subcommittee on Oversight will begin the third day of hearings to discuss a series of administration proposals to improve this Nation's single-employer, defined benefit pension plan system.

Last month, the Departments of Labor and Treasury presented to this subcommittee the administration's proposals for dealing with pension plan funding and asset reversions. Earlier this week, the Pension Benefit Guaranty Corporation, PBGC, presented its variable rate premium proposal. We have also received testimony from the CBO, the GAO, representatives of employers, and representatives of retirees.

Today, we will hear from witnesses representing employees, pension plan actuaries, and others affected by changes to the current system. When considering the merits of major reform to a system as broad, and as important as this pension program, it is essential that the subcommittee hear directly from those who are affected. Therefore, we welcome your important contribution.

The subcommittee intends to analyze each witnesses' testimony and report to the full committee recommendations for a reform package, a well-balanced proposal dealing with any needed PBGC premium rate changes; improvements in the funding of single employer defined benefit pension plans; and, rules on the withdrawal of assets from overfunded plans.

With this in mind, we will begin the hearings but first let's hear from Congressman Dick Schulze, ranking minority member.

Mr. SCHULZE. Thank you, Mr. Chairman.

I am pleased to join you in continuing our hearings on the administration's proposals for pension plan funding reform and a variable rate premium.

Dr. Utgoff traced the evolution of the PBGC premium and described the events which have caused the PBGC deficit. She then presented the administration's proposal for a variable rate PBGC premium.

She said it was necessary to change the incentive and opportunity for imprudent employers to maintain underfunded pension plans. This is the objective of the administration's proposal for pension reform and a variable rate PBGC premium. The other witnesses were split in their opinions of the variable rate premiums. Some management witnesses said the variable rate approach was equitable and efficient, others criticized it as too large an increase.

The witnesses for retiree groups generally supported a variable rate premium but expressed opposition to withdrawals from overfunded plans. Today we shall hear from organized labor, pension professionals and employee witnesses. I am eager to learn their position on the pension reform proposals and the variable rate PBGC premium.

Mr. Chairman, I look forward to hearing from today's witnesses.

Mr. FLIPPO. Thank you very much.

Our first panel today, we are pleased to have you here. We have Larry Smedley, who is the Deputy Director for the AFL/CIO in Occupational Safety, Health and Social Security. We have the UAW representative, Dr. Hoffman, director of Social Security Depart-

ment and from the United Steelworkers, Mr. Jack Sheehan, assistant to the president.

Thank you for coming today and we look forward to hearing your testimony. Please proceed as you deem appropriate.

**STATEMENT OF LAWRENCE SMEDLEY, ASSOCIATE DIRECTOR,
DEPARTMENT OF OCCUPATIONAL SAFETY, HEALTH AND
SOCIAL SECURITY, AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS**

Mr. SMEDLEY. The AFL-CIO appreciates the opportunity to present our views on the administration's proposals for the funding and termination of defined benefit plans.

Let me quickly summarize some of our major concerns with the administration's proposals. First, in regard to asset withdrawals, the administration provides employers with an alternative to termination by allowing them to tap excess assets without terminating the pension plan which is the only way they can get those so-called excess assets at the present time. In our opinion, that proposal has several major flaws. Let me mention just two:

First, if the employer uses the withdrawal method they must have a 25-percent cushion. If they terminate, they have 25 percent more in assets because they are not required to have a cushion. So clearly there is still an incentive to terminate rather than to use the withdrawal mechanism.

Obviously there must be stronger disincentives to discourage terminations.

Second, in our opinion the so-called excess assets are actually the deferred wages of active workers and retirees. Yet on termination the proposals make no provision in any way for retirees or active workers to share in the assets which are their deferred wages.

I would point out, Mr. Chairman, that the Advisory Council on Health, Welfare and Benefit Plans to the Department of Labor, appointed by the Secretary of Labor, which was requested by him to look into the asset reversion issue, recommended that workers and retirees share in surplus assets when a termination takes place.

It is unfortunate that the Secretary of Labor rejected the recommendations of his own Advisory Council. We hope Congress will do better.

Of all the administration proposals, the minimum funding standards would have the greatest immediate impact and would hit hardest on troubled industries. In short, such standards must strike a balance between the need to soundly finance a pension plan and to avoid the kind of impact that could lead to the ending of business operations, layoffs, and termination of pension plans.

In short, the minimum funding standards must be modified to reduce their cost impact.

Now, of great concern is the requirement that if a plan termination liability exceeds its assets then the assets of the other control groups' pension plans must be transferred to the terminating plan to cover its liabilities.

The effect of this is to transfer assets among participants of different plans. We are opposed to any proposal which would allow an employer to grab excess assets of a collectively bargained pension

plan, override the provision of a collectively bargained agreement and give assets to a nonunion pension plan.

Similarly we oppose the proposal that would allow transfer of excess assets from a pension plan to a health retiree benefit plan unless both plans were part of the same collectively bargained agreement.

The variable rate premium which the administration recommended this week would be in addition to the per capita or flat rate premium now in effect. As we understand the proposal, the premium could be as high as a hundred dollars per participant and with additional surcharges for funding wavers could reach as high as \$220.

The employers most effected by these excessive premiums would be troubled employers in distressed industries. These are the same employers which would bear the brunt of the administration's proposed minimum funding standards. In other words, they get a double whammy.

The impact in some cases could cause major layoffs, cessation of business operations, and termination of plans. We don't think that Congress would want to put such an onerous and additional burden on these hard-pressed employers.

Mr. Chairman, the per capita premium or flat rate formula was chosen at the time of the passage of ERISA for several reasons. One, it was easy to understand, it was simple to administer, and it placed the least financial pressure on those employers least able to bear the burden. In short, we oppose the variable rate premium.

Mr. Chairman, because of the limited time available for my presentation, I had to concentrate on those parts of the administration's proposals that we found most unsatisfactory.

However, we do concede that the administration's proposals represent a comprehensive plan and a serious effort to deal with the termination and funding of pension plans. Some of them are unsatisfactory, but many of them deserve support.

For that reason the AFL-CIO is willing to work with other groups interested in strengthening the termination insurance program.

We commend the subcommittee for their efforts, and we would be happy to work with you on this important task.

[The prepared statement follows:]

**STATEMENT BY LAWRENCE SMEDLEY, ASSOCIATE DIRECTOR
AFL-CIO DEPARTMENT OF OCCUPATIONAL SAFETY, HEALTH AND SOCIAL SECURITY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS
ON ADMINISTRATION PROPOSALS FOR THE FUNDING AND
TERMINATION OF DEFINED BENEFIT PENSION PLANS**

April 9, 1987

On behalf of the AFL-CIO, I wish to thank you for the opportunity to present our views on the Administration's proposals for the funding and termination of single-employer defined benefit pension plans. We commend you for holding these hearings and for the energetic way you have tackled the policy issues and the problems facing the Pension Benefit Guaranty Corporation (PBGC).

The passage of the Employee Retirement Income Security Act (ERISA) laid to rest the "gold watch" theory of private pensions -- that pensions result from employer generosity and did not belong to workers. Congress clearly recognized the concept that private pensions are a form of deferred wages. ERISA moved us into the era in which the private pension system would be held socially accountable; where workers' pension rights and the duties of those who control workers' pension funds would be subject to public control through law.

No section of ERISA had greater support from organized labor than Title IV which created the Pension Benefit Guaranty Corporation (PBGC). In spite of PBGC's recent problems, the AFL-CIO is convinced that it has been largely successful in accomplishing the program's intended objectives. We remain strongly committed to the termination insurance program.

We are deeply concerned with the problems which have developed under the single-employer termination insurance program and hope that satisfactory legislation to resolve them will soon be forthcoming.

Asset Withdrawals

When a pension plan is included in a collective bargaining agreement, both parties explicitly or implicitly acknowledge that it is, in fact, a part of the wages and conditions of employment which workers are to receive in exchange for their labor. In short, a collectively bargained pension represents current wages withheld to pay a benefit on retirement.

To many, the fact that a collectively bargained retirement plan is a form of compensation may seem too obvious to require further argument. Nevertheless, it is a point worth remembering and emphasizing. It has a very important bearing upon many questions which are bound to arise with regard to the rights of workers under a pension plan.

The Administration's proposal generally permits employers to recover so-called "excess assets" from ongoing defined benefit plans provided that certain conditions are met. The objective is to provide employers with an alternative to termination by allowing them to tap excess assets without terminating the plan.

An employer would be permitted to withdraw assets from an ongoing defined benefit plan to the extent that, after the withdrawal, the value of the assets and of the assets in the other plans of the employer and of the control group of which the employer may be a part exceeds a "minimum benefit security level." Only amounts in excess of 125 percent of plan liabilities measured on a termination basis, or the amount determined by a formula based on a projected unit credit method, would be available for withdrawal. For annuitized benefits, the amount of the cushion would be reduced. A ten percent excise tax and the appropriate income tax would be applied to all withdrawals as well as termination reversions.

In our opinion, the proposal would encourage employers to choose termination rather than using the withdrawal option since, in a termination, an employer could take back all the excess assets (subject to taxes), but in a withdrawal would have to keep an asset cushion in the plan. The objective should be to discourage not encourage terminations.

Though the terminating employer could not establish another defined benefit plan for five years, this so-called "five year curse" would do little to deter terminations. The employers would, at best, replace the defined benefit plans with defined contribution plans. The result would be to undermine defined benefit plans which provide workers with better retirement protection.

The proposal would also encourage employers to annuitize the liability of retirees by permitting a lower cushion when this is done. Plans often grant ad hoc cost of living increases to retirees when they experience investment gains and/or have excess assets. Unfortunately, the taking of plan assets by employers would greatly reduce that possibility and transferring the plan's retirees to an insurance company through the purchase of annuities would virtually eliminate any possibility for such increases.

As pointed out earlier, employer contributions paid into a pension fund have been earned by workers. The amounts contributed by the employer to finance the pension credits accumulated by each worker should, therefore, be an irrevocable payment which the employer cannot withhold or recapture just as an employer cannot withhold or recapture cash wage payments.

The Department of Labor's own Task Force on Asset Reversions and its Advisory Council on Health, Welfare and Benefit Plans have recognized this principle by suggesting that workers and retirees share in surplus assets when a termination takes place. In addition, both groups felt it imperative to insure there

is no incentive to terminate because the employer could do better by terminating than using the withdrawal option. They dealt with both problems by recommending, that on termination, workers and retirees share an amount equal to the cushion required on a withdrawal.

Both the Task Force and the Advisory Council also recommended that a withdrawal of assets be considered an experience loss and amortized over 10 years. Congress should include such a provision in any legislation on termination reversions that includes a withdrawal mechanism.

Minimum Funding Standards

Of all the Administration's proposals, the minimum funding standards would have the greatest immediate impact. Plans would be required to fund unfunded liabilities within a minimum range of three to five years to a maximum of the number of years remaining under the plan's existing amortization base.

Underfunded plans are defined as those which have assets less than 110 percent of termination liabilities. Special minimum funding rules would apply to these plans based on a Funded Ratio. This ratio would be the actuarial value of plan assets divided by 110 percent of the plan's termination liability to participants. The lower the plan's Funded Ratio, the shorter the amortization period.

In the event of a funding decline, a minimum amortization base would be created by multiplying the plan's termination liability after the decline by the amount of the decline in the ratio. This amount would have to be amortized over three years.

Waivers from minimum funding requirements would be greatly restricted. The proposal requires that waived contributions be amortized within a period of years determined by multiplying 15 years by the plan's funded ratio and, in no case, could the result exceed 15 years. The general tightening of the waiver standards

would appear to virtually disqualify plan sponsors from funding waivers except in cases of hardship resulting from temporary cash flow problems. Plan sponsors, who are severely impacted by the minimum funding standards, would either not qualify for a waiver or it would be of very limited value in helping them deal with their financial difficulties.

Unfortunately, the Administration proposals do not provide a schedule detailing the relationship between Funded Ratios and amortization periods. However, it is clear that the amortization period for the liabilities of some plans could be as short as three to five years as compared with the current 30 years.

It is obvious that these funding proposals would have a major cost impact on some employers. These employers, for the most part, are more numerous in troubled industries. Layoffs, early retirements and deferred funding in order to deal with pressing financial problems have prevented them from achieving actuarial funding assumptions for their pension plans. Employers that could otherwise survive might be pushed over the edge by these funding standards.

Funding standards must strike a balance between the need to soundly finance pension plans and avoidance of the kind of impact that could lead to cessation of business operations and termination of the plan. In short, requiring excessively rapid funding at the time a company is experiencing economic difficulties would, at the very least, make its survival more difficult and could cause its demise. The end result could place a greater burden on the PBGC, not less.

We are aware that to require employers to improve the funding of their pension plans will in the long run strengthen retirement security for workers. But the proposed standards do not differentiate between the prosperous and hardship cases and would disproportionately impact on the latter. Any changes in minimum funding standards must be realistic as to their cost burden and economic impact on pension plan sponsors.

The Administration's proposals for the funding and termination of defined benefit pension plans deal with PBGC's long run problems. Thus, any realistic changes, though taking longer to increase funding levels, will avoid serious adverse impact on financially troubled employers and will accomplish the same result.

However, in the last analysis, strengthening of the economy is the most effective means of protecting the PBGC. This will require trade and economic policies that will enable plan sponsors to achieve profitability and to stay in business so that they can continue their plans and maintain their funding obligations.

Let me now turn to some positive features of the proposed minimum funding standards.

Liability for the funding requirements would be on a control group basis. This would force employers to be responsible for, and to plan pension financing, on a comprehensive basis covering all their plans.

If a plan's Funded Ratio is less than 100 percent, the plan would have to make annual contributions at least equal to the annual benefit payout plus administrative expenses. Under present law, a pension plan can, in some situations, meet minimum funding standards and still continue to have its unfunded liability increase. It is important to plug this loophole.

The deadline for minimum required contributions would be accelerated to 2½ months after the close of the plan year, from 3½ months now. This would strengthen plan funding.

Termination of Underfunded Plans

The Administration proposals make a number of major revisions in the provisions of current law pertaining to pension plan liability when an underfunded plan is terminated. Some of these proposed changes are to the benefit of

participants. For example, in a distress situation, the employer's liability for unfunded benefits would be increased to the plan's termination liability.

Similarly, the required plan asset level for a standard termination would be raised from the benefit commitments standard of present law to the full level of the plan's termination liability to participants. In spite of the improvements enacted in the single-employer termination insurance program last year, profitable employers can still evade responsibility for certain non-guaranteed benefits. This provision would help with these kinds of problems.

Of great concern, is the requirement that, if a plan's termination liability exceeds its assets, the assets of the control group's other plans would have to be transferred to the terminating plan to cover its liability, provided the transfer does not reduce the assets in the ongoing plan to less than the plan's termination liability. This would result in transfer of assets among plans with different participants.

As we have emphasized, a pension plan is not a conditional or discretionary gift by the employer. Rather it represents current wages withheld to pay a benefit on retirement. This proposal could result in employers taking the deferred wages which workers have won through collective bargaining and transferring them to non-union pension funds.

When investment earnings are high and a pension plan well funded, a union can negotiate benefit improvements or larger wage increases or a combination of both. Also ad hoc cost of living adjustments for retirees can take place. We are opposed to any proposal which would allow an employer to grab the assets of a collectively bargained pension plan and use these assets to benefit a non-union pension fund.

These provisions would also prohibit an employer from establishing plans that provide substantially similar benefits within five years after termination of a plan that did not have adequate assets to provide PBGC guaranteed benefits. Since no legislative language yet exists for the Administration's proposals, we cannot be sure of the exact meaning of this provision. However, it appears to prohibit the negotiation of substantially similar benefits even when no new PBGC liability is created. This would be unwarranted and unnecessary intrusion into the collective bargaining process.

Retiree Health Benefits

If an employer is entitled to a withdrawal of surplus assets from a pension plan, such assets could be transferred to accounts covering health benefits of current retirees. Assets transferred in this manner would be exempt from the taxes that would be applicable in the cases of withdrawals or reversions.

We have no objection to this procedure in those cases where the transfer of assets involves the same group of employees covered by the collective bargaining agreement. As in the case of transfers to pension funds, we strongly object to this when the transfer of assets is among plans with different participants since the result could be the transfer of collectively bargained deferred wages of union workers to non-union health plans. We assume, of course, there is no intention to interfere with the right to make such transfers the subject of collective bargaining.

Variable Rate Premium

The Administration has just sent to Congress legislative proposals for modifying the PBGC premium structure. The PBGC is recommending a variable

rate premium in addition to the per capita approach now used to finance the program.

A variable rate premium is based on the difference between a plan's assets and its unfunded vested liabilities. Contrary to the claim of its proponents, this kind of a premium does not fairly distribute the premium burden. The risk of an employer terminating a pension plan is not necessarily correlated with the funding levels of its pension plan.

A prosperous employer in a growing industry may have greater liabilities, often simply because the plan is newer, than a troubled employer in a depressed industry. In some cases, these economically healthy employers would pay higher premiums to cover costs arising from the termination of plans often sponsored by employers paying lower premiums. Similarly, two plans with the same amount of unfunded liability would pay identical premiums even though the funded ratio of one might be much less than the other.

The result will be to discourage the establishment and continuation of defined benefit plans and to cause employers not to grant prior service credits. Thus, workers would have less satisfactory retirement protection.

The total premium could be as high as \$100 per participant per year. In addition, there would be a surcharge related to the number of funding waivers granted a plan which could in some cases produce a funding charge of \$220 per participant. Both the per capita rate and the maximum funding charge would be indexed - the first to the increase in wages and the latter to 1.5 times wage growth.

The employers most affected by these exorbitant premiums would be troubled employers in distressed industries. These same employers would bear the brunt of the Administration's proposed minimum funding standards. The impact could in some cases cause major layoffs or even cessation of business operations. Surely,

Congress would not want to put such onerous and additional burdens on these hard pressed employers.

The PBGC has a social purpose and is more than just an insurance company. When political decisions lead to the decline of certain industries neither the employees or employers should bear the full cost of this restructuring. The effects of these dislocations and the resulting cost impact on PBGC should be shared and not targeted at those who already have disproportionately borne the burden.

The per capita premium formula was chosen at the time of the passage of ERISA because it was simple to understand, easy to administer, and placed less financial pressure on those employers least able to bear the premium burden. These criteria are as valid today as they were then.

The AFL-CIO will oppose a variable rate premium. We would support an increase in the PBGC per capita premium or a combination of an increase with a permanent indexing of the premium.

Conclusion

The Administration's proposals constitute a comprehensive plan and a serious effort to deal with the problems resulting from pension plan terminations. Many of them are unsatisfactory but others deserve support.

Though there may be differences on the specifics of what should be done, the Administration and all responsible individuals and organizations now agree that something must be done. The AFL-CIO stands ready to work with other groups interested in strengthening the termination insurance program.

Mr. Chairman, we commend you and the subcommittee for the efforts that you are making and will be happy to work with you on this important task.

Mr. FLIPPO. Thank you very much for your testimony.

Of course, we will include the full testimony in the record. We appreciate your summary.

Dr. Hoffman.

STATEMENT OF WILLIAM S. HOFFMAN, PH.D., DIRECTOR, SOCIAL SECURITY DEPARTMENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)

Mr. HOFFMAN. Thank you, Mr. Chairman.

I am William Hoffman, director of the UAW Social Security Department. With me is Allen Ruther, our union's associate general counsel. I am appearing on behalf of 1.5 million active and retired UAW members and their spouses, most of whom are participants in the defined benefit pension plans.

The UAW commends you for holding hearings on the critical issues associated with the funding and termination of these plans.

Our union is very proud of the role we played over the past 30 to 40 years in this struggle to achieve adequate and secure retirement income for workers and their families. We have been active both at the collective-bargaining table as well as in the legislative arena.

It is clear that action is needed to address this problem and to assure that the funding status of existing pension plans do not deteriorate in the future thereby focusing participants and secondarily the PBGC to further losses.

We must approach solutions to these problems with precision and great care. We submit that a so-called solution which undermines the defined benefit pension systems ability to provide adequate retirement income through overly conservative stringent requirements is no solution at all. We need a balanced approach between retirement income needs on the one hand and funding and other provisions in anticipation of termination on the other.

We believe that the most urgent need is to provide additional financing for the PBGC. The \$8.50 premium is insufficient to cover PBGC anticipated claims and current deficit. The UAW would support an immediate increase in the PBGC premium. We would support provision for additional increases in the future or a permanent indexing of the premium.

We also believe that other sources of revenue for PBGC should be considered such as earmarking the excise tax on reversions.

We would support making employers fully liable for all proposed pension benefits both under a standard and a distressed termination.

Recently the PBGC proposed to modify the existing premium structure to be based on underfunded vested liabilities of the pension plan. We strongly oppose this variable rate premium proposal. PBGC proposal would drastically increase premiums for some employers to \$100, some even to \$220 per participant for employers who obtained funding waivers.

This could cause serious financial difficulties for certain economically troubled companies. It would also discourage formation of defined benefit plans and encourage some companies to terminate their existing plans. The PBGC proposal is fundamentally unfair

because it does not reflect at all the actual risk that a plan would be terminated and have to be taken over by the PBGC. It is unfair because it would basically require a small number of companies who currently maintain plans with unfunded liabilities to shoulder virtually the entire burden of paying for the additional liabilities that have recently been assumed by the PBGC as a result of the recent steel terminations.

We strongly object to the purpose which underlies the PBGC variable rate proposal, namely that companies should be discouraged from ever creating unfunded liabilities by charging them higher premiums. Unfunded liabilities in pension funds primarily result when credit for past service is recognized at the time benefit increases are provided or when a plan is initially established.

This is a very desirable practice which permits pensions more adequately to meet current retirement income needs. More generally, the UAW submits that the problems of assuring adequate funding of pension plans would be better addressed through direct changes in the minimum funding standards rather than through variable rate premium proposals.

We recognize that some changes in the minimum funding standards are appropriate to assure that the funding status of existing plans don't deteriorate in the future. In making such changes we would again stress the need for balance between security of financing and adequate income for retirement. We would support the principal of a cash-flow test which would require that contributions to a plan exceed benefit payments and expenses for each year. This would assure the funding status of the plan does not deteriorate.

We also would support making the entire control group of a plan sponsor liable for pension funding.

We support also the principal of accelerating the due date for pension contributions. We believe it would be appropriate for the Government to consider requiring faster funding for newly created pension liabilities. If such funding requirements are limited to new liabilities and these requirements are gradually phased on over a period of years, we believe that faster funding can be implemented without disrupting the defined benefit pension system and without creating undue economic hardships for those employers who are already experiencing financial difficulties.

The administration's proposal for faster funding for existing pension liabilities causes us great concern. It is apparent that plans that are less than fully funded for all accrued benefits could be subjected to faster funding for all liabilities.

This could in fact shorten the amortization period for existing unfunded liabilities in some plans to as little as 3 to 5 years. Moving from current law to such a short period could double or even triple pension costs for existing benefits, even 15-year amortization could increase costs by 30 percent. Had the administration proposal been in effect when Chrysler was in difficulty, I am not sure if Chrysler would be here today.

In recent years there has been a growing problem associated with employer's terminating pension plans in order to obtain the reversion of so-called excess assets. As a matter of principal, the UAW submits that any excess assets can and should belong entire-

ly to plan participants. However, we recognize that there are contrary views.

In the interest of furthering a legislative compromise that would provide an early solution to this problem the UAW is willing to support legislation that would provide for some equity sharing of the excess assets between participants and employers. We must stress, however, that we cannot support legislative proposals unless they provide at a minimum that upon termination of any plan any excess assets must first be used to compensate active and retired participants for the legitimate benefit expectations which have been frustrated by the termination.

Only after such dealing could in fact the moneys revert to the employer.

Mr. Chairman, we do have other points. They are in our full testimony. I appreciate the opportunity to be here today. We are also very anxious to work with you in solving this problem.

Thank you.

[The prepared statement follows:]

Statement of William S. Hoffman, Director, Social Security Department, International Union, United Automobile, Aerospace & Agricultural Implement Workers of America, UAW

Mr. Chairman, my name is William Hoffman. I am Director of the UAW's Social Security Department. I am appearing today on behalf of 1.5 million active and retired UAW members and their spouses, most of whom are participants in defined benefit pension plans. As such, we represent about 5% of the participants in our nation's defined benefit pension plans. The UAW commends you for holding hearings on the critical issues associated with the funding and termination of defined benefit plans, and for your past efforts in support of the private pension system.

We are proud of the role the UAW has played in the struggle to achieve adequate and secure retirement income for workers and their families. We have been active in this pursuit for nearly forty years at the collective bargaining table, as well as in the legislative arena.

In 1950, UAW members struck the Chrysler Corporation to establish the principle that pension plans should be adequately funded. Chrysler's approach was to pay pension benefits out of its general treasury, instead of funding them through a trust fund. The UAW insisted that the pension benefits be funded in order for the pension promises to be secure. After striking for 104 days, the UAW finally prevailed. The principle that pension benefits should be funded became the standard pattern for UAW negotiated contracts.

The UAW was also one of the first organizations to call for the enactment of federal legislation establishing minimum funding standards for all pension plans. We wholeheartedly supported the funding standards that were ultimately included in Title I of the Employee Retirement Income Security Act of 1974 (ERISA). Most UAW collective bargaining agreements already required 30 year funding of past service liabilities. Nevertheless, we recognized that the enactment of statutory minimum funding standards was necessary for pension plans.

In our judgment, the minimum funding standards mandated by ERISA have been a success. They have played an important role in assuring that most pension plans are adequately funded.

However, when Congress enacted ERISA, it recognized that the establishment of minimum funding standards would not be enough to solve the "Studebaker" type of problem which had so shocked the conscience of the nation - that is, situations in which workers and retirees lost a substantial portion of their vested pension benefits because a company experiencing severe economic difficulty terminated its pension plan and the plan had insufficient assets to pay all vested benefits. To address the "Studebaker" problem, Congress also provided for the establishment of the pension plan termination insurance program in Title IV of ERISA.

The UAW believes that the termination insurance program has been largely successful in achieving its intended objectives. The Pension Benefit Guaranty Corporation (PBGC) has been instrumental in guaranteeing that thousands of participants and beneficiaries received at least a portion of their anticipated benefits when economically-troubled companies terminated their pension plans and there were insufficient assets to pay all vested benefits.

In 1986, after years of debate, Congress finally enacted the Single Employer Pension Plan Amendments Act (SEPPAA). This legislation greatly strengthened the termination insurance program by providing the PBGC with a long overdue premium increase, and by closing loopholes in ERISA which had enabled some profitable employers to dump unfunded pension liabilities onto the PBGC and to evade responsibility for certain vested non-guaranteed benefits which had been earned by participants. However, developments since the enactment of SEPPAA demonstrate that additional legislation is required to address a number of problems facing the defined benefit pension system.

Several pension plans with large unfunded liabilities have recently terminated. In particular, the termination of the LTV Steel pension plans has nearly doubled the PBGC's liabilities. These terminations and the resulting increases in PBGC's liabilities make it clear that some action is needed to address the PBGC's financing problems. Some action is also needed to assure that the funding status of existing pension plans does not deteriorate in the future, thereby exposing the participants and the PBGC to further losses.

We must approach solutions to these problems with precision and great care. A so-called "solution" which undermines the defined benefit pension systems' ability to provide adequate retirement income through overly conservative, stringent requirements is, I submit, no solution at all. We need a balanced approach between retirement income needs in an ongoing plan on the one hand and funding and other provisions in anticipation of termination on the other.

In addition, there is a need for action to resolve the various abuses which have occurred in recent years in connection with the termination of so-called "over funded" plans and the reversion of excess assets to employers. Let me address each of these issues in turn.

Financing of the Pension Benefit Guaranty Corporation (PBGC)

The UAW believes that the most urgent need is to provide additional financing for the PBGC. The \$8.50 premium is insufficient to cover PBGC's anticipated claims and current deficit. The recent LTV pension plan terminations added in excess of \$2 billion of unfunded liabilities to the PBGC's \$2.3 billion shortfall. Increased financing is needed to eliminate this deficit as well as to cover anticipated claims.

The UAW supports an immediate increase in the PBGC premium. We support provisions for additional, annual premium increases in the future or a permanent indexing of the premium. We also believe that other revenue sources, such as earmarking the excise tax on reversions for the PBGC, should be considered by Congress. And we would also support initiatives to deal separately with the large pension liabilities associated with the troubled steel industry.

The UAW supports making employers fully liable for all promised pension benefits, both under a "standard" and a "distress" termination. In our judgment, this will help to provide increased protection for participants, and also will have a positive impact on the financial condition of the PBGC.

The PBGC has recently submitted a proposal to Congress to modify the existing premium structure so that it would be based upon the unfunded vested liabilities of a pension plan. The UAW strongly opposes this variable rate premium proposal for a number of reasons.

The PBGC's proposal would drastically increase the premiums for some employers to \$100 per participant (and even up to \$220 per participant for employers who obtain funding waivers). Such a drastic increase in the premium could cause serious financial difficulties for certain economically troubled companies. It would also discourage the formation of new defined benefit plans, and encourage some companies to terminate their existing plans. All of this would be counterproductive and harmful both to plan participants and to the long-run financial condition of the PBGC.

The PBGC's proposal is also fundamentally unfair because it does not reflect at all the actual risk that a plan will be terminated and have to be taken over by the PBGC. Thus, under the PBGC's proposal, some large financially healthy employers would be charged very high premiums because their plans have unfunded liabilities, even though there is very little risk that the plans will be terminated and the liabilities transferred to the PBGC. On the other hand, small employers would pay the lowest premium even though there may be a much greater risk that their plans will be terminated and have to be taken over by the PBGC.

In addition, the PBGC's proposal is unfair because it would basically require a small number of companies who currently maintain plans with unfunded liabilities to shoulder virtually the entire burden of paying for the additional liabilities that have recently been assumed by the PBGC as a result of the LTV plan terminations. The UAW submits that if the PBGC premium has to be increased to deal with the LTV related liabilities, at a minimum these costs should be distributed as broadly as possible over all employers that maintain defined benefit plans. Ideally, these costs should be assumed by society as a whole. But certainly it is wrong to single out a small group of employers to pay for the costs associated with the LTV plan terminations.

When the pension plan termination insurance program was established in 1974, it was intended to be a social insurance program under which all employers that maintain defined benefit pension plans would be required to share equally in paying for the costs

associated with the termination of underfunded plans. The PBGC's variable rate premium proposal would violate this basic principle of social insurance, by effectively requiring 2 percent of the plans covering only 7 percent of the participants to pay 30 percent of the total premiums collected by the PBGC. In our judgment, such a drastic change in the PBGC's premium structure represents the first step towards "privatization" of the entire termination insurance program, which the Administration has repeatedly announced is its long-term objective.

The UAW also strongly objects to the premise which underlies the PBGC's variable rate premium proposal — namely, that companies should be discouraged from ever creating unfunded liabilities by charging them a higher premium. Unfunded liabilities in pension funds primarily result when credit for past service is recognized at the time benefit increases are provided or when a plan is established. This is a very desirable practice which permits pensions more adequately to meet current retirement income needs. Such increases in liability are amortized over a period of years much like a home mortgage. For most employers, these unfunded liabilities do not present any risk to the PBGC. The companies are financially healthy and can manage the increased costs. The PBGC's variable rate premium proposal will simply discourage such economically healthy employers from granting credit for past service (and even from granting cost of living increases to retirees), and thus will undermine the retirement income needs of participants.

The PBGC's premise that employers should never create unfunded liabilities in their pension plans can be analogized to the notion that individuals should always pay cash for a home, rather than taking out a mortgage which may be paid over a period of years. The net result would be to make it virtually impossible for many individuals to ever afford to own a home. Similarly, if employers are discouraged through a variable rate premium from paying for past service liabilities over a reasonable period of time, pension plans will never be able to afford to provide participants with a decent level of retirement income.

Finally, the PBGC's proposal that employers be required to pay a premium surcharge whenever they obtain a funding waiver would actually conflict with the policies underlying the minimum funding standards. If the IRS, in consultation with the PBGC, has determined that a company needs a funding waiver because it is in financial difficulty, then it makes no sense to hit the company with a premium surcharge, thereby aggravating the company's economic difficulties. More generally, the UAW submits that the problem of assuring adequate funding of pension plans should be addressed directly through changes in the minimum funding standards, rather than indirectly through a variable rate premium proposal. As discussed below, the UAW believes that a number of changes can be made in the minimum funding standards which would ensure that pension plans are better funded, without unduly burdening employers and the private pension system. These funding changes would reduce the PBGC's exposure, and eliminate the need for drastic changes in the premium structure such as those proposed by the PBGC.

Minimum Funding Standards

Pension plans are generally better funded today than in 1976 when ERISA's minimum funding standards became effective. The recent termination of several pension plans with large unfunded liabilities should not be viewed as evidence that ERISA's minimum funding standards have failed.

Nevertheless, the UAW recognizes that some changes in the minimum funding standards are appropriate to assure that the funding status of existing plans does not deteriorate in the future. In making such changes, we would stress that a balance must be struck between retirement income needs and funding security.

The UAW supports the principle that a cash flow test should be established which would require that contributions to a plan exceed benefit payments and expenses for each year. A cash flow test would assure that the funding status of a plan does not deteriorate. Had such a provision been in effect, it would have prevented the assets of the Allis Chalmers and the LTV Steel salaried plans from deteriorating.

The UAW also strongly supports making the entire controlled group of a plan sponsor liable for funding the plan. This will help assure that funding continues in

situations where the controlled group is solvent, notwithstanding the demise of the plan sponsor itself.

The UAW also supports the principle of accelerating the due date for pension contributions.

The UAW supports a requirement that the IRS evaluate the entire controlled group of a plan sponsor in deciding whether a waiver is appropriate. However, we are opposed to proposals to tighten the standards for granting a waiver and the amortization periods for repaying waived contributions. The IRS already has wide discretion over whether and under what terms a waiver should be granted. We do not believe it would be useful to put the IRS in a straightjacket, especially since these determinations must necessarily depend on the facts of each particular case.

It is also important to recognize that actuarial assumptions have a large impact on employer contributions to a pension plan. These assumptions vary tremendously from plan to plan and employer to employer. The UAW believes these assumptions should be more carefully scrutinized by the IRS and, where appropriate, challenged.

In addition to the various changes discussed above, the UAW believes it would be appropriate for the government to consider requiring faster funding for newly created pension liabilities. Faster funding of newly created liabilities, such as future benefit improvements, would assure that these liabilities are funded on a more conservative basis and would also result in better funding for all plans. If such funding requirements are limited to new liabilities, and these requirements are gradually phased in over a period of years, we believe that faster funding can be implemented without disrupting the defined benefit pension system and without creating undue economic hardships for those employers who are already experiencing serious financial difficulties. We would note, however, that any proposals for faster funding must be coupled with reforms (discussed below) relating to the reversion of "excess" assets upon the termination of a plan since faster funding would otherwise aggravate the already serious problems which have arisen in this area.

The Administration's proposals to require faster funding for existing pension liabilities cause us great concern. Despite repeated requests, the Administration has not released details on the new amortization schedules which would be required under their proposals. Thus, it is impossible to determine what the precise impact would be on any particular plan or employer.

Notwithstanding the lack of specificity, it is apparent that the Administration is proposing that plans which are less than fully funded for all accrued benefits could be subjected to faster funding for all unfunded liabilities. I would like to emphasize that this accelerated funding proposal would apply to existing liabilities. This amounts to changing the rules in the middle of a game and is unfair. Moreover, it would impose serious financial hardship on some employers, and could also endanger the adequacy of retirement monies provided by the defined benefit pension system.

Under current law unfunded liabilities are amortized over thirty years. Liabilities which were in existence prior to 1976 were allowed to be reamortized over forty years.

The Administration would shorten the amortization period for existing unfunded liabilities for some plans to as little as three to five years. Moving from current law to such a short period could double or even triple pension costs for existing benefits. Even fifteen year amortization of existing liabilities could increase such past service costs by 30%. Had such a proposal been enacted when Chrysler was in financial trouble, Chrysler might not have recovered. This would have been counterproductive and harmful to the PBGC, as well as the workers and retirees of Chrysler.

The issue which must be addressed here is one of balance. It is important to properly fund a pension plan. It is also important to maintain a pension system that meets current retirement income needs. To reduce the amortization period of existing liabilities, as the Administration proposes, would dramatically and unnecessarily increase costs and, I believe, significantly undermine the retirement income available to workers and retirees.

Reversion of Excess Assets to an Employer

In recent years there has been a growing problem associated with employers terminating pension plans in order to obtain a reversion of so-called "excess" assets — that is, assets in excess of the amount needed to cover all accrued benefits. These termination-reversions have frustrated the legitimate retirement expectations of thousands of workers and retirees. They have also raised a serious threat to the stability of and confidence in the private pension system.

Unfortunately the Administration has chosen to ignore this problem and the recommendations of the Task Force on Reversions appointed by Secretary Brock and of the ERISA Advisory Council concerning termination-reversions. Instead of building on the groundwork established by the Task Force and Advisory Council, the Administration has developed a new proposal — a proposal which appears to be guided solely by a desire to protect the interests of the PBGC, rather than the interests of plan participants.

As a matter of principle, the UAW submits that any "excess" assets should belong entirely to the plan participants because the pension contributions represented deferred wages. However, we recognize that there are contrary views on this point. In the interests of furthering a legislative compromise which will provide an early solution to the problems posed by termination-reversions, the UAW is willing to support legislation that would provide for some equitable sharing of the "excess" assets between participants and employers. We must stress, however, that the UAW cannot support any legislative proposal in this area unless it provides, at a minimum, that upon the termination of a plan any "excess" assets must first be used to compensate active and retired participants for the legitimate benefit expectations which have been frustrated by the plan termination. Only after such benefit expectations have been satisfied should assets be allowed to revert to the employer.

There are many arguments for allowing active and retired participants to share in a portion of the excess assets. Under the Internal Revenue Code, contributions to a "qualified" pension plan are immediately tax deductible for employers. However, one of the conditions which must be met in order for a pension plan to be "qualified" is that the plan must be intended to be permanent. In many cases, the reason pension plans have assets in excess of their termination liability is precisely because the plans were terminated prematurely. For example, in salary-related plans the excess assets typically represent monies that were contributed for the purpose of funding benefits which would have been paid had the plan continued and salaries increased. Similarly, in flat-benefit plans the excess assets may often result from the fact that many workers are just shy of eligibility for early retirement benefits, such as an unreduced lifetime benefit or supplementary benefits payable until the age at which Social Security benefits commence. In addition, premature termination of a pension plan clearly jeopardizes the future retirement security of participants by effectively foreclosing the possibility of future cost of living and real income increases. For all of these reasons, active and retired participants have a right to share any excess assets which exist when a plan is prematurely terminated.

In our judgment, the Administration's proposal is fatally flawed because it fails to recognize this basic principle. But the Administration's proposal also contains numerous other problems.

Under current law, an employer may receive a reversion of excess assets upon the termination of a plan only if the plan contains express language allowing such a reversion. The Administration's proposal would effectively repeal this rule, and allow employers to obtain reversions regardless of the plan provisions (and indeed, even if the plan expressly prohibited reversions). The UAW believes that this proposed dilution of the protections afforded by existing law is outrageous, and we trust that Congress will not countenance such suggestions.

The Administration has also proposed that employers be permitted to withdraw a portion of the excess assets from an ongoing plan. However, the way the proposal is structured, the amount of assets an employer could obtain upon termination of a plan would often exceed the amount which could be withdrawn from an on-going plan. Thus, the Administration's proposal would not discourage employers from terminating plans, it would simply give employers an additional mechanism for obtaining access to "excess" assets. This simply does not make sense. The UAW submits that any withdrawal mechanism should be considered only if it is coupled with sufficient restrictions on

termination-reversions so that employers will be discouraged from terminating their plans. In addition, sufficient assets should always be left in the plan to cover all accrued benefits plus the additional amount which would be paid out to participants if the plan terminates. The withdrawal should be treated as an actuarial loss for funding purposes. In order for a withdrawal to take place, the plan should have language which permits a withdrawal.

The Administration's proposal also would require that the excess assets in a particular pension plan be transferred to other pension plans maintained by the same employer or other member of that employer's controlled group in various situations. This part of the Administration's proposal violates the exclusive benefit rule which lies at the heart of ERISA's fiduciary duty provisions. The UAW submits that it would be fundamentally unfair to require pension funds which have been contributed on behalf of one group of participants (and which represent deferred wages for those participants) to be suddenly transferred to another pension plan for the benefit of an entirely different group of participants. The Administration's rationale for this proposal, presumably, is to provide maximum protection for the PBGC. But this puts the cart before the horse. The basic objective of our pension laws should be to promote the interests of participants, not the interests of a government agency.

The Administration's proposal also contains a number of elements that would tend to undermine the defined benefit pension system. Specifically, the Administration has proposed that employers be allowed to receive a larger reversion if they terminate all of their defined benefit pension plans. The Administration has also proposed that employers be precluded from establishing any new defined benefit pension plans for the same group of participants for a period of five years after the termination of an underfunded or overfunded plan. The UAW submits that these proposals are ill-conceived and counterproductive. Rather than strengthening the defined benefit pension system they would encourage employers to flee the system (thereby further undermining the PBGC).

The Administration has also proposed that employers be granted an additional tax incentive if, upon withdrawing excess assets from an ongoing pension plan, the employer immediately transfers those assets to a fund which would be used to provide health insurance benefits to current retirees. The problems associated with providing adequate and secure health care benefits to retirees are extremely complex and difficult. The proposal advanced by the Administration, however, will not provide any meaningful solution to those problems. Even worse, the Administration's proposal would countenance the transfer of pension assets from one group of participants, such as rank and file workers, to an entirely different group of persons, such as salaried retirees. Again, this violates the exclusive benefit principle and is fundamentally unfair.

The termination of pension plans with a reversion of so-called "excess assets" to employers remains an area of serious concern to the UAW. The UAW is willing to work with the Administration and Congress in fashioning a proposal which will stop the serious abuses in this area and recognize the legitimate benefit expectations of participants.

In closing, I would like to emphasize the importance of pension plans to the retirement income security of UAW members and other working and retired Americans. Defined benefits plans are the best vehicle for providing this security:

1. They allow increases in benefits for past service thus allowing periodic benefit adjustments to meet current income needs.
2. They have the flexibility to provide adequate levels for disability retirement benefits, survivor benefits and early retirement benefits.
3. They do not place investment risk on the plan participant.
4. They allow the plan sponsor reasonable flexibility in funding.

The UAW strongly supports sound pension funding. It is now apparent that some adjustments in the minimum funding requirements of ERISA are needed, as well as additional financing for the PBGC. As these needs are considered, we urge you to balance them with other needs; the needs of participants in defined benefit plans to continue to have these plans provide them with adequate levels of income, as well as to have their benefits securely financed.

The UAW would again like to thank Chairman Pickle for holding early hearings on these important issues. On behalf of the UAW, I want to express our wish to work with you in shaping solutions to these problems.

Thank you.

Mr. FLIPPO. Thank you. Mr. Sheehan.

**STATEMENT OF JOHN J. SHEEHAN, LEGISLATIVE DIRECTOR,
UNITED STEELWORKERS OF AMERICA**

Mr. SHEEHAN. Thank you, Mr. Chairman.

We have appended to our testimony the statements we made on the Senate side which is a little bit more elaborate and I thought we would just leave that for your staff to read.

This morning I would concentrate on another aspect. The bankruptcy filing of LTV under the chapter 11 of the Bankruptcy Code for the purpose of reorganizing its debt has galvanized attention on the issue of pension guarantees and I might add health care benefits for retirees, although this latter issue is not the subject matter of these hearings.

It is hard, however, for a retiree to separate the two issues because, for many LTV former employees, there is an actual and a potential substantial reduction in both types of benefits. The actual pension benefit reduction is well known. The Pension Benefit Guaranty Corporation does not guarantee the continuation of the full pension payment for those workers who, due to plant shutdown or steel capacity reduction, received early pension benefits.

The steel industry has been undergoing substantial restructuring, resulting in a severe impact upon employment. Since 1979, we have suffered a 52-percent reduction in jobs. It is only natural, therefore, that social adaptation measures would be utilized to absorb the adverse consequences. These measures have primarily consisted of early pension benefits. Without these measures, steel restructuring would have been more abrasive than it actually has been and certainly more socially unacceptable.

However, when a company files for reorganization bankruptcy and terminates its pension plan, such retired workers lose their total both promised and received coverage.

Future structurally unemployed workers are deprived of any access to shutdown pension benefits, thereby assuring increased social pressure and social problems. In steelworker contracts, closure benefits consist of the full benefit otherwise payable at normal age of retirement—provided certain eligibility requirements of age and length of service are met—and a \$400 a month supplement to bridge the worker to social security eligibility.

Under PBGC the supplement is not guaranteed and the pension benefit is subject to an actuarial reduction, dependent upon the age of the retiree at the time of termination from employment.

Furthermore, there is a potential reduction of health care benefits because the retirees insurance claims are considered as other credit obligations subject to modification and rejection.

Additionally, these benefits are not as secured as the pension benefits. As restructuring pressures continue and resort is made to the bankruptcy courts, not only in the steel industry, but in other industrial sectors, the private sector health care system will be put under serious strain as to its credibility relative to employees and retirees.

PBGC impacts: also, the the active workers, in terms of his future benefits, and the retiree, relative to his current benefits, are

suffering deep losses as the result of pension terminations, the impact on the PBGC is also under review. Prior to the termination of the LTV pension plans, the agency had already accumulated approximately \$2 billion in deficits. Hence, there was a financial problem which had to be addressed. Furthermore, according to PBGC, the recent losses are attributable to a handful of terminated plans.

USWA definitely supports the objective of the administration's proposal, namely, the maintenance of the solvency of the PBGC. There are two pressure points that should be considered in the present situation.

One, the premiums to be collected and the degree of underfunding of pension plans.

With regard to the premiums, we object to the administration's contention that the flat rate per capita premium is a major cause of the pension insurance program's deepening financial problems. Instead, attention should be directed at the level of underfunding in pension plans.

Emphasis should be placed upon advancing the funding status of these plans. From a union point of view, such a prospect might withdraw the economic incentive to shift these liabilities through a termination of pension plans. When a plan is terminated not only is PBGC affected, workers are hurt, despite the guarantee provided by the PBGC. Additionally, of course, the PBGC incurs a deficit which could have been lower if the termination was unavoidable, but the plan more fully funded.

At the outset, it should be stated that USWA does not view the PBGC as a restructuring agency for companies which are reorganizing. Perhaps the restructuring steel industry should have other options other than the termination of pension plans. According to testimony given by the ERISA industry, if the liabilities of several bankrupt companies within the steel industry were removed from PBGC's books, the current \$8.50 premium level would be more than sufficient to amortize the PBGC's remaining liabilities. The development of these options would be directed at increasing the capability of restructuring firms, like those in steel, to more fully fund their pension plans.

Mr. Chairman, in the next section, we also join with the AFL-CIO and UAW in rejecting the variable interest rate. We are really considering it to be a penalty rather than a revenue collecting mechanism and a penalty on companies that have underfunded plans for reasons that are more economic in nature rather than the fault of the company.

I would like to pass over the next pages merely for the purpose of getting at emphasizing on page 6 that we support a more rapid funding of pension plans although we indicate that you have to be careful about not pushing too far.

I would suggest that perhaps a steel specific measure might be in order. As already indicated, the termination of pension plans by some firms in the steel industry represents a substantial portion of PBGC's claims, approximately 80 percent are due to steel company terminations. It would be most appropriate to consider measures to alleviate the threat which additional terminations pose for the PBGC and steelworkers. Two aspects of such a consideration would

include disaggregating the cost of accelerated plant shutdown pension benefits from the cost of the benefits payable at normal age of retirement.

A substantial cause of underfunding of steel plans results from the pace of restructuring. Older employees are either forced to accept or are eligible for early pension benefits while the industry is downsizing its work force in a relatively short time period.

These so-called exit costs are a new phenomenon which has pushed some of our pension plans to the brink of termination. It should be noted that not all steel companies have out of control financing problems, but enough have. If these costs could be segregated until the industry stabilizes, a great deal of the funding pressure would be released. Actually, this impact is a one time event covering workers usually between the age of 50 to 65 who might otherwise have continued working in the steel mills but for the restructuring.

It is the cost of these benefits which would be separated for the purpose of a special financing arrangement. Because of steel restructuring, the payment of these retirement benefits are advanced, thereby immediately increasing the underfunding status of the pension plans, the financing burden of which is an inducement to termination.

I will just make reference to the fact that we made comments as to whether you could access the accumulated tax credits which the steel industry has due to net operating losses and to advance or to rebate these earmarked specifically for early retirement benefits and therefore offset them from the pressure that is currently facing the steel industry and which might indeed push them into further terminations.

Thank you, Mr. Chairman.

[The prepared statement follows:]

TESTIMONY

of

JOHN J. SHEEHAN, LEGISLATIVE DIRECTOR
UNITED STEELWORKERS OF AMERICA

Bankruptcy Events

The bankruptcy filing of LTV under Chapter 11 of the Bankruptcy Code for the purpose of reorganization of its debt has galvanized attention upon the issue of pension guarantees and, I might add, health care benefits for retirees, although this latter issue is not the subject matter of these hearings. It is hard, however, for a retiree to separate the two issues because, for many LTV former employees, there is an actual and a potential substantial reduction in both types of benefits. The actual pension benefit reduction is well defined. The Pension Benefit Guaranty Corporation does not guarantee the continuation of the full pension payment for those workers who, due to plant shutdown or steel capacity reduction, received early pension benefits.

o Pension Benefits Impacts

The steel industry has been undergoing substantial restructuring, resulting in a severe impact upon employment. Since 1979, we have suffered a 52% reduction in jobs. It is only natural, therefore, that social adaptation measures would be utilized to absorb the adverse consequences. These measures have primarily consisted of early pension benefits. Without these measures, steel restructuring would have been more abrasive than it has been and certainly more socially unacceptable. However, when a company files for reorganization bankruptcy and terminates its pension plan, such retired workers lose their total promised and received

coverage. Future structurally unemployed workers are deprived of any access to shutdown pension benefits, thereby assuring increased social problems. In Steelworker contracts, closure benefits consist of the full benefit otherwise payable at normal age of retirement (provided certain eligibility requirements of age and length of service are met) and a \$400-a month supplement to bridge the worker to social security eligibility. Under PBGC the supplement is not guaranteed and the pension benefit is subject to an actuarial reduction, dependent upon the age of the retiree. This is a severe blow.

o Health Care Benefits Impacts

Furthermore, there is a potential reduction of health care benefits because the retirees' insurance claims are considered as other credit obligations subject to modification and rejection. Additionally, these benefits are not as secured as the pension benefits. As restructuring pressures continue and resort is made to the bankruptcy courts, not only in the steel industry, but in other industrial sectors, the private sector health care system will be put under serious strain as to its credibility relative to retirees.

o PBGC Impacts

While the active worker, in terms of his future benefits, and the retiree, relative to his current benefits, are suffering deep losses as the result of pension terminations, the impact on the PBGC is also under review. Prior to the termination

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of the LTV pension plans, the agency had already accumulated approximately \$2 billion in deficits. Hence, there was a financial problem which had to be addressed. Furthermore, according to PBGC, the recent losses are attributable to a handful of terminated plans. USWA definitely supports the objective of the Administration's proposal; namely, the maintenance of the solvency of the PBGC. There are two pressure points contributing to the financial situation: the premiums collected and the degree of underfunding of terminated plans.

Premiums: Per Capita vs. Variables

We object to the Administration's contention that "the flat-rate per capita premium is a major cause of the pension insurance program's deepening financial problems." Instead, attention should be directed at the level of underfunding in pension plans. Emphasis should be placed upon advancing the funding status of these plans. From a union point of view, such a prospect might withdraw the economic incentive to shift these liabilities through a termination of pension plans. When a plan is terminated, workers are hurt, despite the guarantee provided by the PBGC. Additionally, of course, the PBGC incurs a deficit which could have been lower if the termination was unavoidable.

At the outset, it should be stated that USWA does not view the PBGC as a restructuring agency for companies which are reorganizing. Perhaps the restructuring steel industry

should have options other than the termination of pension plans. According to testimony given by the ERISA Industry Committee, if the liabilities of several bankrupt companies within the steel industry were removed from PBGC's books, the current \$8.50 premium level would be more than sufficient to amortize the PBGC's remaining liabilities. The development of these options would be directed at increasing the capability of restructuring firms, like those in steel, to more fully fund their pension plans.

o Variable Rates - A Penalty

The solution, however, does not lie in developing a variable or risk-related insurance premium system which would more heavily penalize troubled firms--the very ones which should be encouraged not to terminate their plans. When the premium rate was first debated by the Congress in 1974, a variable rate system was rejected. Termination of plans in risk-related firms was not an event which could actuarially be determined. Neither should it be considered a "fault" of the company which would draw a penalty of a heavier premium. Furthermore, underfunding of pension plans might be due to economic circumstances beyond the control of plan administrators; e.g., accelerated payment of early pension benefits, sharp cyclical decreases in active employees, interest rate fluctuations, etc. Instead, these should be considered as economic realities, the liabilities of which

should be borne equally through a uniform per capita rate system.

o Increased Per Capita Premium

There is no doubt that the current economic situation confronting PBGC needs to be addressed, although its crisis is not imminent. The agency has reported: "Payments to current retirees are not at risk in the immediate future and there is sufficient time to make necessary changes. But the need for changes must not be ignored. The PBGC is able to meet all of its present liabilities until the year 2003. Nevertheless, the short-term aspect of the present deficits should be alleviated and can be resolved by a very modest increase in per capita rate. USWA would suggest provisions for additional, annual premium increases or a permanent indexing of the premium. The Administration's proposal might not only not solve PBGC's short-term problem, but could precipitate even greater shortfalls. Furthermore, even more workers will be subjected to loss of benefits and coverage by defined benefit plans if troubled companies are forced to cancel pension arrangements in order to avoid premium rates as high as \$100 per worker.

A switch to a risk-related premium is a substantive change in the PBGC financing arrangement and constitutes a profound departure from the social insurance concept adopted by Congress in 1974. The PBGC is not a private sector

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insurance company and, while it should not endure large deficits, it should not be run like a private corporation.

The fallacy of the variable rate approach is that the Administration expects 39.8% of the new premiums, designed to defray the PBGC's deficits, to be collected from 4.7% of the plans in the "troubled industry" sectors.

Faster Funding Standards

Resolution of the present short-term deficits through a flat premium increase, however, must be accompanied by measures to increase the funding of the pension plans. In general, USWA supports the Administration's intention to revise the minimum funding standards but cautions that Congress must carefully balance the necessary improvements in funding requirements with the goal of preserving defined benefit plans and the employers who sponsor them. Appended to this statement are more elaborate USWA comments before the Senate Labor Committee on the Administration's proposals.

Steel Specific Measures

As already indicated, the termination of pension plans by some firms in the steel industry represents a substantial portion of PBGC's claim--approximately 80%. It would be most appropriate to consider measures to alleviate the threat which additional terminations pose for PBGC and steelworkers. Two aspects of such a consideration would include:

- o Disaggregating the cost of accelerated plant shutdown pension benefits from the cost of the benefits payable at

normal age of retirement. A substantial cause of underfunding of steel plans results from the pace of restructuring. Older employees are either forced to accept or are eligible for early pension benefits as the industry is downsizing its workforce in a relatively short time period. These so-called "exit costs" are a new phenomenon which has pushed some of our pension plans to the brink of termination. It should be noted that not all steel companies have out-of-control financing problems--but enough have. If these costs could be segregated until the industry stabilizes, a great deal of the funding pressure would be released. Actually, this impact is a one-time event covering workers usually between the age 55 to 65 who might otherwise have continued working in the steel mills but for the restructuring. It is the cost of these benefits which would be separated for the purpose of a special financing arrangement. Because of steel restructuring, the payment of these retirement benefits are advanced, thereby immediately increasing the underfunding status of the pension plans, the financing burden of which is an inducement to termination.

o Financing the cost of these special retirement benefits up to normal age of retirement would be dependent upon a separate source of funds. Suggestions have been offered that an import surcharge might be appropriate. Equally appropriate would be early access of steel firms to accumulated tax credits from net operating losses (NOLs). The industry can draw on these credits over a period of 15 years. However,

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due to the depressed conditions in the industry, these credits will not be exhausted in the short term. Access to these credits now, conditioned upon an earmarking of the rebates exclusively for retirement benefits and nontermination of pension plans, could relieve the immediate pressure of steel pension plans and an overloading of the PBGC. Furthermore, the financing of the pension benefits contractual obligations would remain the responsibility of the private sector individual firms, which negotiated them, although there would be annual treasury advances in the early years to be discounted in later years.

Since each steel company has early pension costs and accumulated NOLs, there would be no competitive differential treatment among the companies as now occurs with PBGC assuming the pension costs only of those reorganizing companies who terminate their plans.

CONCLUSION

In summary, Mr. Chairman, the Steelworkers Union agrees that the PBGC's financial situation needs to be stabilized:

- o An increase in the per capita premium instead of a variable rate premium would resolve the present deficit situation.
- o A longer-term resolution lies in a more rapid funding by companies of their pension obligations. For deeply underfunding plans in troubled industries, a transition would

be necessary so that such companies would not elect to terminate their plans.

o A steel-specific solution would greatly relieve the pressure of the PBGC since 80% of its current claims are steel-industry originated. Such a program, financed by advancing steel industry tax credits, would avoid the pressure to terminate pension plans because of the immediate burden to finance closure-related retirement benefits--the so-called exit costs. While the threatened impact upon the PBGC would be alleviated, so, also, would the potential loss of the defined benefit pension plan for workers be removed and early pension measures would remain available to facilitate steel industry restructuring.

Administration Proposals

As has been indicated, there is a need for legislative changes to enhance the security of presently underfunded pension plans.

o The Administration does not consider expanding beneficiary coverage for early pension benefits. However, USWA, recognizing the need for this type of a social measure where restructuring exists, acknowledges that special funding provisions should be adopted to fund these benefits on an estimated basis, based on honest projections of the likely number of qualifying events in the near future, or requiring the funding of these benefits on a pay-as-you-go basis, thus imposing the funding obligation at the time the employer actually closes or idles a facility.

o Minimum funding standards are too lenient relative to actuarial assumptions. Annual scheduled contributions of pension obligations allow "balloon" payment at the end of the year, thereby inducing waiver requests which further cause underfunding.

o Legislative changes for rapid funding are in order but not at a rate as disruptive as the Administration's proposal which could cause discontinuance of the pension plans of troubled companies. The proposed 3-5 year amortization period is too stringent.

o Transition rules should be adopted so that adjustments could be made to different funding standards. A prospective application to new liabilities, which are created after the enactment of the new standards, could also help in the transition phase.

o USWA recognizes that the Administration's proposals on the timing of a waiver request and the consideration of the financial circumstances of the controlled group may be appropriate. However, the proposed amortization is too restrictive for troubled companies. The SEPPA provisions requiring in certain circumstances the providing of security for a waiver should be given an opportunity to determine its effectiveness.

o The employer should be liable for not only the guaranteed or basic benefit, but the total promised benefits.

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o "Excess assets," which for the most part result from investment returns and not excessive contributions, should remain available to protect or improve benefits. Neither reversions upon plan termination nor withdrawals from ongoing plans should be permitted. These assets are needed to protect against future inflation or subsequent plan difficulties. Nor should assets of terminated plans or plans acquired in a business transaction be transferred to other unfunded plans maintained by the employer.

o USWA supports the provision of transfer of plan assets to fund retiree health and life insurance benefits--but only if the pension plan is being terminated, provided the beneficiaries are not limited to those retired at the time of the transfer, but are limited to the benefit employees; i.e., those covered by a particular plan. The ultimate solution to the problem of unfunded retiree insurance promise entails, in addition to adverse funding, some combination of Medicare improvements, a PBGC-type insurance or national health insurance. In the short term, there is also an urgent need to reform the bankruptcy laws to provide retirees with special safeguards against routine reductions.

o Tax restrictions on the pre-funding of health care plans should also be relaxed.

o USWA rejects the intervention of PBGC in the company-union collective bargaining efforts initiated after the termination of pension plans whereby one of the objectives is to negotiated "follow-on" programs to protect retired workers against some of the amounts of their benefits lost by the PBGC guaranteed benefits being lower than the non-guaranteed benefits.

STATEMENT

of

JOHN J. SHEEHAN
Legislative Director of the
UNITED STEELWORKERS OF AMERICA

on the subject of

THE FUNDING AND TERMINATION OF PENSION PLANS

at the Joint Hearing Before the

Subcommittee on Labor-Management Relations
Committee on Education and Labor
U. S. House of Representatives

and

Subcommittee on Labor
Committee on Labor and Human Resources
U. S. Senate

Washington, D.C.
March 24, 1987

On behalf of the United Steelworkers of America, I welcome this opportunity to address the important issues associated with the funding and termination of defined benefit pension plans, and the Administration's proposals for legislative action in these areas. We commend Senator Metzenbaum and Representative Clay for holding these timely hearings, and thank the Subcommittees for the opportunity to present the Steelworkers' views.

The Steelworkers played a leading role in the enactment of the Employee Retirement Income Security Act, the landmark legislation that established minimum vesting and funding standards, as well as fiduciary standards, for all pension plans and that created the federal pension termination insurance program. We are proud of the role that our Union played in that effort and in subsequent efforts, such as last year's Single-Employer Pension Plan Amendments Act, to improve on the pension protections afforded to employees and their families.

The termination insurance program of Title IV of ERISA has been of enormous benefit to retirees, both in the steel industry and in the nation as a whole. The unfortunate fact is that, over the past several years, the domestic steel industry has been in chaos, with a number of steel companies driven to bankruptcy. We are all painfully aware of the LTV Steel bankruptcy, the largest bankruptcy in United States history. That case embraces three steel companies: Jones & Laughlin Steel, Republic Steel, and Youngstown Sheet and Tube. And we have witnessed and lived through the bankruptcies of Wheeling-Pittsburgh Steel and Mesta Machine, both based in Pittsburgh. Continental Steel in Indiana also filed for bankruptcy and subsequently ceased

operating, and many of its workers were completely deprived of early retirements when the PBGC terminated the pension plan. Last month, Kaiser Steel of Los Angeles entered Chapter 11. It joined, among others, McLouth Steel of Detroit, Phoenix Steel in eastern Pennsylvania, Eastern Stainless Steel of Baltimore, and Guterl Steel and Roblin Steel in the Buffalo area. I could name many, many other smaller companies, and any number of steel foundries. The length of this list is indeed shocking.

In most, if not all, of these cases, the financial plight of the companies has led to the termination, or the threatened termination, of the companies' pension plans. Where the pension plans have been terminated, the Pension Benefit Guaranty Corporation has guaranteed many -- but by no means all -- of the pension benefits for retirees and their families. I cannot overstate the critical importance of the PBGC's guarantees for employees and retirees in the steel industry, for their families, and for their communities.

While the main focus of today's hearing is on the funding and termination of pension plans, the wave of bankruptcies and the accompanying loss of pension and retiree health benefits in steel and other basic industries cannot be ignored.

For the past six years, we have implored the government to prevent the very kinds of problems we discuss today through the development of an industrial policy. We are aware that the steel industry is in the throes of restructuring, during which time the acceleration of steel imports eroded the industry's ability to respond to the restructuring pressure. As a result,

a chaotic course has been followed as capacity is being reduced in a nonefficient manner. But more than that, there has been an unbelievable toll on workers, retirees, and their communities. While belated action was taken against the onslaught of dumped and subsidized steel that robs American of their jobs and retirement security, it has been inadequate and the unrestrained restructuring proceeds without any rational consideration of the consequences.

To address the pension problems confronting the American industry, Congress must adopt, among other more comprehensive measures, forceful trade legislation. The devastation facing retirees and employers alike, which we describe more fully below, can no longer be ignored.

The Crisis of Early Pension Supplements

Despite the crucial protections that ERISA provides, the fact remains that there is a crisis for tens of thousands of steel industry retirees and their families. That crisis is not addressed by the Administration proposal. That crisis involves early pension benefits.

In the steel industry, the wave of plant shutdowns left many, many workers jobless, and has qualified tens of thousands of workers under age 62 for early pensions. Every one of these individuals would have preferred to work for a full income, but was forced on a pension well before eligibility for Social Security. At LTV alone, there are almost 8,000 early pensioners.

With this problem in mind, the early pensions in the steel industry were designed to pay pension "supplements." These are payments -- usually \$400 per month -- for early retirees who lose their jobs, through no fault of their own, as a result of plant shutdowns, job reductions, extended layoffs, or permanent disability. These supplements are added to an individual's basic monthly pension until he or she qualifies for Social Security, usually at age 62. Like Social Security, the supplement is an essential part of the early pensioner's basic income.

Today's crisis arises because the PBGC does not guarantee the \$400 supplements. Early retirees whose pension plans have been terminated are thus faced with the loss of \$4,800 of their annual income. The loss of these special supplements, by people who have already lost their jobs, is nothing less than tragic.

Allow me to give but a few examples. One man in Aliquippa, Pennsylvania, a married father of five, had been on long-term layoff. He found that even with 27 years seniority, he could no longer hold a job with LTV. After depleting his life savings and selling the family's only car, he finally accepted early retirement. Before the PBGC's recent termination of the LTV pension plans, his monthly income was \$950, which he supplemented with food stamps. The loss of the supplement reduced his monthly income to \$550, and he has been forced to go on welfare.

Another LTV retiree and his wife, both in their late fifties, have had their monthly income reduced to \$267. They find that rent and food alone cost them more than \$270 per month, and they are now living off the local union food bank.

Thousands of LTV, and other steel company, retirees have had their monthly incomes similarly cut by one-third, one-half, or more.

Even more tragically, one Youngstown, Ohio retiree, anxious about his continued health insurance coverage and worried about the loss of his monthly supplement of \$400, was driven to suicide. This fifty-nine year old man, who worked more than thirty-five (35) years in the steel industry, received a net monthly income, including his supplement, of \$622. He worked part time to supplement his LTV Steel pension. Fearful of losing his supplement, he sought and was denied food stamps, household assistance and general relief. His life was destroyed by his anxiety over the loss of retirement income and health insurance. Human tragedies of this sort, reminiscent of the Great Depression, have no place in our society. We fear that, if no relief is forthcoming, there may be other retirees who feel they have no other option but to end their lives.

The Steelworkers have attempted to alleviate the financial hardship for its retired members that results from the loss of pension supplements and other non-guaranteed benefits, including benefits, such as future early or disability retirement benefits, lost by active employees. The Union has negotiated with employers to create new pension plans, known as "follow-on programs," that will pay at least some of the amounts that were lost when the companies' defined benefit pension plans were terminated and the monthly benefits reduced. The PBGC, however, has condemned these programs. Without justification,

it has taken the position that, if such follow-on programs are implemented, it will undo the termination and restore the company's pension plans, reimposing the terminated plans' unmanageable liabilities on these bankrupt employers.

Wheeling-Pittsburgh and the Steelworkers have thus been forced to file suit against the PBGC in the Western District of Pennsylvania, seeking a declaration of their right to establish a Follow-On Program to assist present and future retirees who have been injured by a plan termination. And, at LTV -- after the PBGC itself terminated the pension plans without even informing the Union of its intention -- the PBGC has now objected to the Union's efforts to enforce its collective bargaining agreement with LTV, which independently requires the payment of pension supplements. Again, the PBGC threatens to "un-terminate" LTV's pension plans if any relief is provided to retirees, only a few weeks after the PBGC's sneak attack on the LTV pension plans created those very hardships.

Nothing in ERISA supports the PBGC's position. We believe it clear that ERISA's guaranteed benefit levels were intended as a floor, not a ceiling, on pension benefits. Congress intended those guarantees to protect employees and retirees, not to punish them. Moreover, nothing in ERISA forbids, or even suggests that it is improper, for an employer, in cooperation with its employees' bargaining representative, to attempt to pay promised pension benefits that exceed the PBGC's guaranteed levels.

At Wheeling-Pittsburgh, for example, the Steelworkers have negotiated a new pension program that is paid for by the agreement of active employees to accept \$1.05 per hour less in wages. These contributions fund both a future service defined contribution plan for active employees and a Follow-On Program which is designed to make up for some, but not all, of the losses incurred by retirees and employees as a result of the termination of Wheeling-Pittsburgh's defined benefit plans. Both pieces of the new pension program are defined contribution plans, and therefore are not covered by Title IV's termination insurance program. The new pension program is funded entirely by the agreement of active employees to give up, unselfishly, a portion of their present wages in order to fund a retirement program both for themselves and for their already-retired colleagues. Thus, this Follow-On Program will impose no cost on the PBGC. At bottom, the Follow-On Program would promote what we understand to be Congress' paramount purpose in enacting ERISA -- the assurance that employees with long years of service realize the pension benefits that they had been promised.

As I have said, the legality of the Follow-On Program at Wheeling-Pittsburgh and the Steelworkers' suit to compel LTV to abide by its collectively bargained pension promises are presently the subject of litigation. The courts will determine the employees' and retirees' rights under existing law. The Administration's proposal, however, suggests for the first time that an employer be prohibited from establishing any retirement program, within five years after an underfunded defined benefit

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plan is terminated, if the new program is designed to make up benefits lost as a result of the old plan's termination. While the exact strictures of the Administration's proposal are still unclear, the Steelworkers are unalterably opposed to any amendment to ERISA that would compel retirees and employees to accept only the benefits which PBGC guarantees, and that would prevent the Union from negotiating with an employer to make up, in whole or in part, for its broken pension promises. No such provision presently exists in ERISA. And, we submit, such an amendment would be directly contrary to ERISA's paramount purpose -- to provide income security to retired employees and their families, and to protect the pension commitments that have been made to those employees.

Of course, rejection of the PBGC's misguided position regarding follow-on programs will provide, at best, only a short-term remedy for a part of this problem. The real solution to the pension crisis now being suffered by tens of thousands of steel industry employees is to guarantee these early retirement benefits under Title IV of ERISA. As we have stated, the employees who qualify for these early pension benefits have lost their jobs through the unforeseen tragedies of plant closings, job reductions, extended layoffs, and disability. These \$400 per month supplements form only a fraction of the total liability of any steel industry pension plan. Nevertheless, the supplements, which are paid until the employee can qualify for Social Security, are a crucial part of their retirement income. If ERISA's ultimate purposes are to be achieved and the pension

promises to tens of thousands of employees are to be fulfilled, these benefits, too, must be guaranteed.

The Steelworkers recognize that special provisions concerning funding will be needed if these benefits are to be guaranteed. Alternatives include requiring an employer to fund these benefits on an estimated basis, based on honest projections of the likely number of qualifying events in the near future, or requiring the funding of these benefits on a pay-as-you-go basis, thus imposing the funding obligation at the time the employer actually closes or idles a facility.

I have addressed at some length a specific pension crisis confronting tens of thousands of steel industry retirees. The Steelworkers sincerely appreciate the Subcommittee's attention to this critical social problem, and look forward to working with Congress to fashion appropriate legislative solutions. Only through that process will the pension expectations of the nation's working men and women be truly protected.

Let me turn my attention now more directly to the Administration's proposals in the areas of pension plan underfunding, plan terminations, and employer access to pension plan assets.

Pension Plan Underfunding

As the members of these Subcommittees are well aware, underfunding of defined benefit pension plans has been a problem for some -- although by no means all -- employers in the steel industry. While ERISA's minimum funding standards have been successful in many instances, they have fallen short of assuring adequate funding of all defined benefit plans.

Even prior to the last five years of depression in the steel industry, some steel pensions -- like those in other industries -- were underfunded because the minimum funding standards were lenient. Actuaries, who in large part determine a company's required annual contributions, may have been given too much discretion. Seemingly small changes in assumptions regarding interest rates, investment experience, or retirement expectations can have dramatic effects on actual funding obligations. All too often, actuaries were willing to use overly optimistic assumptions in order to reduce their client's annual funding obligations.

At the same time, the statutory timing for making pension contributions encouraged a lax attitude toward funding by some companies. Because pension obligations were paid in a once-a-year "balloon" payment, which only came due some eight and a half months after the end of the plan year, the annual funding obligation could be regarded as something other than a "real" bill. Some steel companies, especially those with cash shortages, met all of their other bills and left the pension bill for last. Companies rarely set aside money over the course of the year to assure that the proper amount would be available when the pension bill came due. And, when the funding obligation did come due, the cash sometimes wasn't there. These companies then turned to the Internal Revenue Service for funding waivers, which increased the present underfunding of the defined benefit plans.

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Then, of course, the crisis in steel hit. It is a crisis of world overcapacity, and has produced the double bind of rapidly shrinking markets and falling prices. The result has been the well-known wave of plant shutdowns, bankruptcies, and forced joblessness to which I have previously referred. The cash shortages that followed have meant, for some companies, an inability to meet even the existing minimum funding standards. More companies have sought and received 15-year funding waivers. Often, the companies defaulted even on these waivers, only to leave their pension plans that much more underfunded.

Some legislative changes are certainly in order. Too many retirees and employees have seen their pension promises broken. Pension benefits must be appropriately funded to avoid the tragedy of lost retirement income. But Congress must be careful that the establishment of stronger pension funding standards does not create undue economic hardships for already troubled companies. That result would benefit no one, not the troubled companies, not the PBGC, and -- most importantly -- not the pension plan participants. Thus, in establishing pension funding standards, Congress must follow a balanced approach, one which will adequately protect the benefit expectations of workers, but does not disrupt the defined benefit pension system, as we think the Administration's proposal would do.

While more rapid funding of pension liabilities may be one approach, the Administration's proposal causes us great concern. The proposed amortization periods of three to five years are such a drastic change from present law that many of the

nation's more troubled employers might be unable to maintain their present pension plans.

It may be appropriate to apply different funding standards to new liabilities, which are created after the enactment of this legislation. Such a prospective application would limit the adverse impact on existing underfunded plans, yet would help avoid the creation of future underfunded liabilities.

Another possibility which the Steelworkers support is an industry-specific approach, addressing not only pension funding problems, but the costs of retiree insurance as well. The onslaught of imports has already affected, for example, the steel industry, and threatens others. Revenues could be raised through a duty on imports and dedicated to funding the pension and health insurance promises made to retirees and employees. While a detailed mechanism remains to be developed, we believe that this approach more fairly addresses a wide-ranging social problem, rather than shifting the burden solely to the retirees and employees themselves, struggling employers or the PBGC.

The Steelworkers are also concerned about the Administration's proposals regarding the availability and amortization of funding waivers. While changing the timing of a waiver request and considering the financial circumstances of the controlled group may be appropriate, the Administration's suggested standards for granting a waiver and paying it back are unduly restrictive. Such changes would often eliminate the beneficial effects of funding waivers. The Single-Employer Pension Plan Amendments Act has already given the Internal Revenue Service

useful new tools to apply in the funding waiver process, including the requirement that in certain circumstances an employer provide security for a waiver. In our view, these changes should be given an opportunity for meaningful application before further restrictions are imposed.

The Steelworkers believe that other legislative changes contained in the Administration's proposal are in order. Actuarial assumptions should be carefully scrutinized, so as to prevent the intentional underfunding of pension plan obligations. We agree that pension obligations should be funded on a more current basis. The Administration's proposal of quarterly funding, with the total annual obligation being paid no more than two and a half months after the end of the plan year, makes good sense. We also support the principle of a cash flow test, in general requiring that annual contributions to an underfunded plan exceed benefit payments and expenses for the year. The Steelworkers endorse the proposition that each member of the employer's controlled group should be jointly and severally liable under the minimum funding rules with respect to each ongoing defined benefit plan. Finally, the Steelworkers agree that tax deduction limits should be revised to allow an employer with an underfunded pension plan to contribute in excess of the otherwise applicable deduction limits. It simply makes no sense as a matter of pension policy to punish an employer that seeks to improve the funding of its underfunded defined benefit plans.

In each of these areas, we look forward to seeing, and to assisting in the development of, proposed statutory language.

The goal of all changes in this area must be to improve the funding of underfunded pension plans. As we have already noted, industry-specific solutions also may be appropriate. In considering this critical area, however, an appropriate balance must be found so that the survival of employees and pension plans is not undermined.

Plan Terminations

The Steelworkers wholeheartedly endorse the Administration's proposal to make employers fully liable for all promised pension benefits, both under standard and distress terminations. The paramount purpose of ERISA is to protect employees' and retirees' expectations in their pension benefits. That purpose is best served if an employer is liable not only for its "benefit commitments," as defined in present law, but for all pension benefits that had been promised.

In addition, the Steelworkers believe that any legislative changes in ERISA must address the PBGC's deficit. Whenever a plan becomes underfunded and then terminates (despite improved minimum funding standards), and whenever an employer is unable to pay all promised benefits (despite increased employer liability), the PBGC must be able to provide the necessary pension insurance for retirees and their families.

The PBGC's present premium is too low. Even though it was recently increased, it remains at only \$8.50 per employee per year. The long-term PBGC deficit, already in excess of four billion dollars, must be addressed in any pension legislation considered by the Subcommittees.

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The Steelworkers support an increase in the PBGC premium, and we would support provisions for additional, annual premium increases or a permanent indexing of the premium. However, the PBGC has, in recent months, suggested modifying the premium structure by establishing a variable or risk-related premium. That concept, which is not yet a legislative proposal, is strongly opposed by the Steelworkers. This proposal could drastically increase the premiums of employers who are least able to shoulder that burden.

The PBGC was created by Congress to protect the pension promises of millions of workers. And, if the nation chooses to allow its industrial and manufacturing base to decline, a choice with which we vehemently disagree, the costs of economic restructuring should not be borne solely by the employees, retirees and the companies which employed them. The recent surge of pension plan terminations is one symptom of restructuring, and the cost of curing the financial problems of PBGC must be shared by all.

Employer Access to Plan Assets

In its proposal, the Administration seeks to address the problem of plans with so-called "excess assets," plans which at a given point in time have assets greater in value than the present value of accrued benefits. This proposal is flawed, however, because it is based on the erroneous assumption that the money held in these tax-exempt trusts, which are dedicated to provide retirement benefits to employees and pensioners, belongs to the employer.

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It is the Steelworkers' position that the contributions made to pension plans belong to the plan participants, both active and retired, not the employer. In bargaining, for example, a part of the cost of any economic package is the contributions made to provide pension benefits. To obtain improved pension benefits, workers forego current income or other fringe benefits. The deferred compensation aspect of pension contributions is best illustrated by a situation where the Steelworkers and employer agreed to a fixed hourly contribution to a defined benefit pension plan. After a period of time, the collectively bargained funding mechanism was altered to eliminate the required contribution, permitting the employer to contribute only the amount the law required. No contributions were needed after the change because the plan was "overfunded," and remained so. The employer later sought to recapture the excess, and the Steelworkers opposed the improper seizure. The fundamental unfairness of the Administration's proposal which provides the employer with the excess is strikingly obvious. Those employees who gave up current wages in exchange for a well-funded future pension would be deprived of their bargain. Their deferred wages would be appropriated for the use of the employer. Even leaving a "cushion" in the plan may not provide adequate protection. If a withdrawal were made and a business reversal occurred shortly thereafter, the plan could be without adequate assets to provide the expected benefits.

In reality, these "excess pension assets" do not represent excessive or mistaken employer contributions; rather, they represent, to a large degree, higher than expected investment returns, caused by inflation and unusual short-term market conditions. That this is so is confirmed by a recent study of the Employee Benefit Research Institute. This study showed that the asset growth of pension funds in recent years resulted from investment returns, not contributions.

The evanescent nature of pension surpluses is well illustrated by the Steelworker's recent experience with a so-called surplus asset situation. Public filings for the corporation showed excess pension assets in the billions, using an interest rate of 9% to value pension liabilities. Upon closer examination, we learned that this figure combined a number of plans maintained by the employer and its wholly-owned subsidiaries, and that the supposed surplus attributable to the contracting employer's plan was in fact half of the reported amount. More significantly, ten months after the filing of these corporate reports, a decrease of 1% in the interest rate, reflecting subsequent market conditions, wiped out almost 60% of the surplus. Permitting withdrawals from ongoing plans, whose liabilities may fluctuate with each swing in the market, jeopardizes the benefit security of plan participants.

In formulating legislation, the Steelworkers propose that neither reversions upon plan termination nor withdrawals from ongoing plans be permitted. Plan assets should remain available to improve the benefits payable to participants, particularly

those paid to retirees and to protect these individuals from the ravages of inflation. Without inflation protection, participants in defined benefit plans see the real value of their benefits deteriorate because of increasing prices. Ironically, the same higher interest rates, which so hurt participants and beneficiaries, generate high investment returns and surplus assets which employers now seek to obtain. In effect, when a reversion occurs, workers and retirees subsidize the employer at a time when they can least afford it.

This result runs contrary to the principle that the assets in a pension fund are "owned" by the workers and retirees and are for their benefit. Workers who gave up wage increases in exchange for employer-pension contributions end up receiving less than the wages deferred. It is this fundamental structural injustice which must be addressed, not exacerbated as the Administration proposal would do.

The need for improved retiree pension benefits, particularly during periods of inflation, cannot be overstated. The usual argument against increasing pension benefits is its high cost. But, if assets remain in the plan, benefits may be improved without necessarily increasing the employer's contribution. This is so because of the impact of inflation on pension costs. Inflation can decrease employer contributions to a defined benefit plan in both real and nominal terms. If inflation gives rise to earnings higher than were predicted by the actuary, the plan will become overfunded, and the employer can reduce his contributions nominally. The decreasing value of a

unit of currency due to inflation reduces the value of this contribution in real terms further still. Even if the investment performance of the fund is not favorable and the employer cannot reduce his costs nominally, inflation can still reduce the value of his costs in real terms. By prohibiting withdrawals or reversions of excess assets, pension reform would recognize that the inflation component belongs to plan members and should be used to protect their benefits.

One troubling aspect of the Administration's proposal is the concept that assets from a terminated pension plan, or a plan transferred in a business transaction, would be moved to other plans maintained by the employer or other members of the controlled group. The injustice of this proposal is illustrated by our prior example of the collectively bargained contribution. Instead of seeing their deferred compensation used to provide pension benefits, the employees would be subsidizing other workers.

Yet another concern the Steelworkers have with the Administration's proposal is the effect it might have on the continued existence of defined benefit pension plans. There is no limit on the amount of a reversion an employer may obtain if it ceases to maintain any defined benefit plans. The penalty of 10% excise tax plus current income tax may be a small price to pay to recapture millions of dollars. Moreover, the proposed five-year ban on the establishment of defined benefit plans serves little purpose, other than to deprive employees of adequate pension income. Indeed, taken in combination with

permitting a full reversion, the five-year ban is an invitation to establish defined contribution plans as permanent features, thus affording more limited retirement protection to employees.

One aspect of the Administration's proposal which the Steelworkers can support in principle is the idea of an incentive for the pre-funding of retiree health and life insurance benefits, so long as the only time pension assets may be used for this purpose is upon the termination of a pension plan.

The importance of retiree medical insurance cannot be gainsaid. In fact, to the retiree on an early pension with serious medical problems, the insurance is even more precious than the pension. Our members worked hard to win retiree insurance at the bargaining table. The Union has struggled to establish the principle that these health and life insurance benefits last for the lifetime of the retiree and surviving spouse. Today, facing a wave of bankruptcies throughout the steel industry, the Union is working to save these retiree benefits in Chapter 11 reorganizations through its support for the Metzenbaum-Stokes bill, the Retiree Benefits Security Act of 1987.

As the Administration recognizes, health insurance is generally not funded and is not guaranteed as pensions are. The ultimate solution to the problem of unfunded retiree insurance promises may very well entail, in addition to advance funding, some combination of Medicare improvements, a PBGC-type system to guarantee retiree insurance promises, or national health insurance. These reforms will not be won quickly or easily,

but in the meantime, consideration should be given to providing appropriate incentives to those employers who have the ability to pre-fund retiree medical and life insurance benefits.

The Administration's proposal permits an employer to use "excess" pension assets to fund retiree insurance, but there is little incentive for an employer to do so. The complex rules of Section 419 of the Internal Revenue Code, which impose stringent limits on pre-funding, must be altered.

There are, however, two (2) problems with the proposed transfer of pension assets to fund retiree health benefits which must be addressed. First, the Administration's proposal limits the group which may benefit to individuals who are retired as of the date of the transfer. The Steelworkers suggest that this limitation is inappropriate since the available pension plan assets are derived from the deferred wages of active employees who will enjoy future retiree benefits as well as those already in pay status. The arbitrary line drawn by the Administration should be eliminated. Second, the proposal does not limit the use of assets to benefit employees and retirees who were covered by the pension plan with the "excess." The Steelworkers suggest that such a limitation is necessary since plan assets should only be used to benefit the individuals covered by the particular plan.

Conclusion

The importance of defined benefit pension plans to the workers and pensioners represented by the United Steelworkers of America, as well as other employees and retirees across the country, is clear. That there are current problems which need to be addressed is apparent to all. As the need for pension reform are considered, Congress must carefully balance the necessary improvements in funding requirements with the goal of preserving defined benefit plans and the employers which sponsor them. The Steelworkers look forward to working with the Subcommittees and other interested parties in shaping appropriate legislation.

Mr. FLIPPO. Thank you very much for your testimony.

Each of you seem to be saying that the PBGC needs additional revenues, maybe I should ask, do you accept the analysis of GAO and CBO that we have an unbalance between the income and the liabilities. If you accept that, how much should the flat rate premium be increased above the current \$8.50 a month; \$12; or \$20? Each of you may want to respond to that.

Mr. SMEDLEY. I think it is very difficult to specifically say what it should be at this time. What you have is two proposals which really blend together. The first administration proposal is a long-run proposal. If you deal with the longrun situation, perhaps make it prospective only in the long run you reach the same result even though you modify the severe funding standards proposed by the administration. When plans are well funded then the problems of the premium will stabilize. So if you deal with the long-run problems you have the light at the end of the tunnel.

Once you have done that, you look at the shorter run premium problem and, at that point, you will know what you need to get to the point where the minimum funding standards will have their effect.

I think that you can handle it then with a per capita or flat rate premium. At least everybody will know the program is stabilized, and that you won't be coming back constantly for more increases.

I can't say what the premium should be at that point. A lot will depend on what you have done with the longer run problem. Then you can gauge what you need in the way of a shorter run premium increase.

Mr. SHEEHAN. I would add one comment, Mr. Chairman. I was impressed by some testimony given that, if you removed the steel limits from the PBGC, the current premium would be sufficient to handle its problems although maybe there is a margin in there that would still have to require a small increase in premiums. But the fact that the steel problem is really the pressure on the whole discussion now, that is why we are suggesting that maybe you might be able to offset the steel pressure through some separate mechanism identified in our testimony.

If that is so, then I think the idea of using the premiums to handle, as Larry said, the short term in problems and to push for even faster funding given all the caveats we talked about, you may be able to keep the PBGC in the status it is anticipated to be in.

Mr. HOFFMAN. The numbers I have looked at indicate \$12 to \$15 depending on whether or not you earmark the excise tax on reversion of excess assets.

I would concur with the previous comments. It is very clear that the steel problem is so overwhelming that it precludes any approach to the solution that can balance the existing present problems with how you want to restructure this minimum funding question and the PBGC liabilities.

I think it is important as you talk about the premium for PBGC though to keep in mind it is easy to—as others I have heard before on this, look at the goal of being able to have a secure PBGC as an end in itself.

I just would like to submit that the real purpose of PBGC is to protect participants, it is not just some insurance company nor

should it be a private enterprise as some would have it, I believe that is the underlying philosophy of their proposals.

Mr. FLIPPO. Thank you. The gentleman from Pennsylvania.

Mr. SCHULZE. Thank you, Mr. Chairman.

I would like to thank the panel for a very interesting and different point of view from their perspective. But I have no questions at this time. I thank the panel.

Mr. FLIPPO. Thank you and I want to thank the panel so much for their summaries. They were short but they were very direct and to the point and we will include your full testimony which contains some very good analysis in the full record.

Thank you so much for your contribution.

Our next panel this morning we have from the American Academy of Actuaries, Mr. Larry Zimpleman, chairman of the pension committee, and we have from the American Society of Pension Actuaries, Mr. Edward Burrows, member of the Government affairs committee.

We appreciate you being with us this morning and being willing to share your views with us on these important matters. As you know, of course, we will include your entire testimony in the record and we would ask you to summarize. I guess you heard those buzzers go off a few minutes ago, we are in session and we could be anticipating a quorum call at any time.

We would appreciate your summary. Please proceed as you deem appropriate.

STATEMENT OF LARRY D. ZIMPLEMAN, CHAIRMAN, PENSION COMMITTEE, AMERICAN ACADEMY OF ACTUARIES

Mr. ZIMPLEMAN. Thank you, Mr. Chairman. It is a pleasure for us to be with you this morning to discuss this important premium for changes in the funding of defined benefit pension plans. My name is Larry Zimpleman. I am a director of pension services for the Principal Financial Group in Des Moines, Iowa. I am here this morning in my role as the chairman of the pension committee of the American Academy of Actuaries.

The American Academy of Actuaries includes within its membership over 85 percent of the enrolled actuaries certified under ERISA to perform actuarial valuations. We view our role as an objective provider of information and actuarial analysis so policy decisions can be made with informed judgments.

It would not be appropriate to criticize the minimum funding standards in ERISA as being inadequate without recognizing they were developed from the standpoint of an ongoing plan. A major part of the administration's proposal is the ability to withdraw excess assets from a defined benefit plan without having to terminate. We have several comments.

No. 1, the test for excess assets is set at approximately 125 percent of the plan termination limit. We are not aware of the specific basis used to develop the 25-percent cushion. A more thorough analysis may be needed to establish the proper amount.

No. 2, the asset reversion implementation guidelines have been in place since May of 1984. We believe these rules have done a good job of striking a balance between employer flexibility and em-

ployee benefit security. The administration proposal may actually reduce employee benefit security because of no requirement for 100-percent vesting of accrued benefits prior to withdrawal, and the inability of an employer to establish a new defined benefit plan for 5 years if he exits the defined benefit system.

Three, the rules on sponsorship and asset transfers will lead to very complex calculations. By terminating a series of plans in a particular order it seems possible to us that an employer can transfer excess assets to a plan for select group of employees. This cannot be done under present law because of the exclusive benefit rules under code S-401(A)(2).

Our area of greatest interest is the proposed change to minimum funding standards. The administration proposes to improve the funded status of plans on a termination basis. Our analysis indicates the proposals will accomplish this.

If it is in the intent of the Congress to change minimum funding standards to a termination plan concept other results will occur. One, contribution requirements for many plans will be increased because of shorter amortization periods for past service liabilities. Our written testimony includes estimates of the increase in funding.

Two, plans now in place which are sponsored by marginally profitable employers may need to be terminated. This may put additional financial burden on the PBGC in the short run.

Three, benefit increases and cost of living increases to retirees will be less likely to occur because of the financial strain of shorter amortization periods.

Although the vast majority of plans are adequately funded, there are plans with financial problems. Why are they underfunded and what can be done about it? Our analysis indicates these chronically underfunded plans are often collectively bargained plans which credit a certain benefit amount for each year of service.

The benefit multiplier is increased at the end of each collective-bargaining agreement. The benefit increase applies to past service as well as future service. In effect benefit increases are granted for prior periods when no funding has taken place. Contributions must increase at a rate much faster than benefits in order to keep up. Current rules on minimum funding limit the funding of the benefit increases.

Future benefit increases whether scheduled to occur or reasonably expected to occur cannot be recognized. We suggest the actuary be allowed to recognize expected future benefit increases. It is similar to the projecting of future salary increases under plans with salary related pension formulas. This allows funding to occur on a more orderly basis recognizing the expected benefit each participant will receive.

We have several other comments on the minimum funding proposals. One, when plan assets reach the funded ratio level, it's likely the investment policy may become more conservative to avoid falling below the 100-percent funded ratio. A more conservative investment policy may not be in the best longrun interest of plan participants.

Two, shorter amortization periods will cause a special burden for new plans. Tax reform changes to the section 415 limits prorates

the limit over ten years of plan participation. We suggest the amortization period for new plans be no shorter than ten years.

Three, the proposal adds a new minimum funding rule based on cash flow during the year. This rule causes the minimum contribution to be volatile for smaller plans. We suggest this rule be dropped.

Four, the proposal requires the minimum funding contribution to be made in a quarterly basis with the final payment within 2½ months of the close of the plan year. We believe this rule is not practical, and any requirement for quarterly contributions should be stopped.

This does not add significantly to benefit security.

Five, the proposal increases the interest rate used to amortize any minimum funding amount that has been waived. This is needless complication that does not add to benefit security. We suggest it be dropped.

The final section of the proposal we will comment on is the termination of underfunded plans. Our comments are brief.

We have not been able to review any of the data used by the PBGC to develop the variable rate premium proposal. We hope this work recognizes the substantial effect that any change in minimum funding standards would have.

Changing the level of PBGC premium is one of only several ways to deal with the PBGC financial burden. Our written testimony includes other ideas. I will mention two. First, change the 5 year phase-in rule for benefit increases. Having benefit increases phased in over 5 years with the shortest period for funding those benefits being over 10 years increases the PBGC exposure.

Second, consider reducing the limit on the PBGC maximum guaranteed benefit. The limit on guaranteed benefits has been indexed upwards from \$9,000 per year in 1974 to \$22,300 today.

The section 415 limit on maximum benefits has only increased from \$75,000 in 1974 to \$90,000 today. Thus, the PBGC is guaranteeing a much greater percentage of the total allowable benefit today than in 1974.

Again, we appreciate the chance to share our thoughts with you this morning. We welcome the chance to work with your staff, Treasury and IRS to produce proposals that will allow our private pension system to enjoy continued success.

Thank you.

[The prepared statement follows:]

STATEMENT OF LARRY D. ZIMPLEMAN
ON BEHALF OF THE PENSION COMMITTEE OF
AMERICAN ACADEMY OF ACTUARIES
TO THE SUBCOMMITTEE ON
OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS

THE ADMINISTRATION'S
PENSION PLAN FUNDING AND PREMIUM RATE PROPOSALS

THURSDAY, APRIL 9, 1987

Larry Zimpleman
Chairman, Academy Pension Committee

We are pleased to have the opportunity to be here this morning and to present our views. The American Academy of Actuaries is a professional association of actuaries formed in 1965 to bring together into one organization all qualified actuaries in the United States and to seek accreditation and greater public recognition for the profession and more effective public service by the profession.

The Academy's primary activities include liaison with federal and state governments, relations with other professions, and the development of standards of professional conduct and practice.

Over 8,400 actuaries in all areas of specialization belong to the Academy. These members are employed by insurance companies, consulting actuarial firms, government, academic institutions, and a growing number of industries. Of special interest, because of these hearings, our membership includes over 83% of the enrolled actuaries certified under ERISA to perform actuarial valuations. Therefore, we have a strong interest in seeing the development of workable and realistic proposals that will continue to allow our private pension system to be successful.

As enrolled actuaries, we believe we have unique insights into aspects of the Administration's proposals that would not be commented on by others. We are happy to have the chance to share these thoughts with you today.

Introduction

We have testified in the past of our belief that we should have a vital, dynamic private pension system. Further, we have suggested that we should have a national retirement income policy in place as a standard against which to measure suggested changes to the private pension system. It is imperative that the Congress review all legislation on employee benefits from the standpoint of retirement security as well as the effect on tax receipts.

There are several key elements that should make up this policy:

1. Retirement income should be adequate. Adequacy should be measured in terms of pre-retirement spendable income. Retirement income from all sources (Social Security, private pension, savings, etc.) should be used to measure adequacy. The employee shares in this responsibility.
2. There should be incentives so that as many people as possible are covered under private pension plans. This is in part a way to ease the financial burden on government programs.
3. We need to recognize changing demographic and working patterns. People are living longer and retiring earlier. People rarely work for the same employer during their entire career. This has financial implications that are quite dramatic for industries that are in different stages of their growth cycle.
4. Not only should retirement income be adequate at retirement, but it should remain so during the retirement years. This issue is also important for those employees who change jobs during their career and may end up with pieces of income at retirement that are not as great as if they had been employed by a single employer.

3. Finally -- and most germane to the hearing today -- the private program must be appropriately funded, thereby spreading the cost ratably over the years to retirement. As enrolled actuaries, we believe we have expertise that will help to focus on this issue. Without adequate funding, all of the other elements of national retirement income policy are meaningless.

Administration Proposals

The executive summary to the Administration's proposals says that public policy should encourage optimal, rather than deficient or excessive, funding of pension obligations. We agree. The difficult task is to define what is meant by "optimal funding".

Over the last few years, a trend has developed that seems to define "optimal funding" in terms of plan termination liability. This has arisen partly because of publicity about the Pension Benefit Guaranty Corporation's (PBGC) losses on recent terminations and partly because of external factors such as standards developed by the Financial Accounting Standards Board (FASB).

While optimal funding should be based on plan termination liability in terms of the PBGC, optimal funding for an ongoing plan may be quite different. We believe that any proposal should consider optimal funding from the standpoint of an ongoing basis, rather than a plan shutdown basis. We will comment later on how some of the specific proposals for change in the minimum funding standard might be changed to operate more on an ongoing plan basis.

Another of the major policy concepts underlying the Administration's proposals is that plan termination rules should be modified so that participants will receive their full accrued benefit and the PBGC will be protected.

The Asset Reversion Implementation Guidelines prepared in May 1984 require that full accrued benefits be provided and that annuitization of benefits occur before plan assets can be recovered in a spinoff/termination or a termination/re-establishment. We believe these rules are an example of a workable, practical approach that provides employers with flexibility and still provides benefit security to employees. The challenge will now be to establish rules that will help borderline plans stay funded to minimize the PBGC's liability.

While it is true that the "cushion" in a defined benefit plan is removed under the Implementation Guidelines, this is really a temporary situation. Our experience indicates that in a typical economic scenario most plans would once again develop sufficient assets within five to ten years following a spinoff/termination or a termination/re-establishment to fund termination liabilities. Any funding problem in such cases tends to be minimal because past service is seldom granted in either instance.

We agree that there are examples where employers will receive excess assets from one plan while at the same time maintaining an underfunded plan that may need to shift liabilities to the PBGC. However, rather than use the controlled group approach, we would suggest that we assist the Administration and the Congress in developing minimum funding rules for all plans that would be more likely to avoid severe underfunding. Having controlled group rules would be a serious impediment to normal business activity and would add to the difficulty of trying to maintain defined benefit plans. We would be happy to expand on this for you.

Employer Access to Plan Assets

The Administration's proposal for withdrawal of assets from ongoing defined benefit plans are quite complicated. As we said earlier, we believe the Implementation Guidelines have worked well and have done a good job of striking a balance between employer flexibility and benefit security to employees. In some ways, the Administration proposal may actually reduce benefit security:

1. There is no requirement for 100% vesting of accrued benefits before any asset withdrawal. The Implementation Guidelines require 100% vesting of accrued benefits and purchase of annuities before any asset reversion.
2. If a plan termination causes an employer (and the controlled group) to exit the defined benefit system entirely, the employer could not establish a defined benefit plan for five years. We see no value in this. Further, once the five year period is up, the employer could establish a defined benefit plan and then grant past service back to the plan termination dates. The Implementation Guidelines do not have this five year rule.

The minimum benefit security is set at 125% of the plan termination liability (subject to a test on the unit credit funding method). First, there are few newer plans that would be funded at this level. Second, we would like to know the basis used to arrive at the 125% figure (and the 110% figure if annuitized).

An example of the way in which asset reversion on plan termination occurs may highlight why these rules are confusing at best. Assume an employer maintains two hourly plans and a salaried plan. Assume all are funded exactly at the minimum benefit security level at all times. By terminating first the hourly plans and then transferring the 25% (or 10%) cushion to the salaried plan, the employer could significantly increase the funding of the salaried plan. This would allow benefits to be increased for the salaried plan and thereby benefit only a select few employees. None of this would be done under present law because of the exclusive benefit rule. We see no justification or rationale for this kind of activity, although use of excess assets for retiree health benefits seems to be appropriate.

The proposed rules on sponsorship and asset transfers are also very confusing. The proposal is meant to deal with the underfunding issue, but in fact requires that some of excess assets be removed from the plans. The focus should be changed to deal with the transfer of underfunded plans from the controlled group. The Multiemployer Pension Plan Amendments Act dealt with an issue similar to this by creating the concept of withdrawal liability. While we are not necessarily endorsing that idea, we believe it is more appropriate to focus on underfunded plans rather than overfunded plans in controlled group situations.

One final point. Our reading of the rules for collectively bargained plans says that an employer will not be considered to have exited from the defined benefit system so long as participation is maintained in a multiemployer plan. As mentioned earlier, it may be necessary to continue in the multiemployer plan to avoid withdrawal liability. Assume the employer terminates all plans (which have excess assets) except for the multiemployer plan. Does all of the excess go to the multiemployer plan? Why?

Minimum Funding Standards

This explanation of the Administration proposal says it is primarily directed at improving the funded status of plans that are underfunded on a termination basis. Our analysis of the proposed changes indicates this will, indeed, occur. However, we would remind the Congress that the minimum funding standards in ERISA were not established with a plan termination concept in mind. We believe it is unfair to criticize these standards as not accomplishing their purpose, since we believe their focus was for proper funding on an ongoing plan basis.

If it is the intent of the Congress to shift the focus in such a way that the minimum funding standards are geared towards a plan termination perspective, that is a separate tax policy decision. However, other results will occur:

1. Contribution requirements for many plans will be increased. This occurs because of the shorter amortization periods. Below is a table showing the increase in the amortization payment needed to move the period up from thirty years (the present minimum funding period).

<u>If Period is Changed to:</u>	<u>The Amortization Payment Increases by:</u>
20 years	12%
10	66%
5	196%
3	335%

These increases are based on a $7\frac{1}{2}\%$ interest assumption.

Since the minimum funding standard includes both normal cost and amortization payment, the minimum funding amount will not increase by this amount. But all contribution levels will be increased.

2. Plans which are sponsored by marginally profitable employers may need to be terminated. This will put further burden on the PBGC in the short run.
3. Benefit increases will be less likely to occur due to the additional financial strain caused by shorter amortization periods. As an alternative, benefit increases will be restricted to future service only.

Based on our experience with thousands of defined benefit plans, the vast majority of plans are adequately funded on both an ongoing and terminating plan basis. Experience from the PBGC shows that 95% of plans that terminate are sufficiently funded to meet liabilities upon termination. While that does nothing to remove the heavy financial burden currently placed on the PBGC, we believe it is important to remember that any changes in minimum funding standards should be geared towards the small minority of the universe that is underfunded.

Which plans are most likely to have funding problems? More often than not, it is a union-negotiated plan with a benefit formula that credits a certain benefit amount (e.g., \$15 or \$20) for each year of service. The common labor practice is then to review the multiple at the end of each collective bargaining agreement and re-establish (increase) the benefit multiplier due to increased employer contributions. Most importantly, this increase in benefit multiplier applies to future service and to past service. In effect, the employer is granting benefit increases for past periods when no funding has yet taken place. The cycle then repeats itself at the end of the next collective bargaining agreement.

Current rules on deductible contributions under Section 404 say the shortest permissible time for amortizing past service liabilities is ten years. Remember that the increases in past service benefits often occur every two or three years. Required deposit levels must increase at a rate much faster than the benefits in order to keep up.

Another problem also limits the funding of these benefit increases. Although there is an established pattern of benefit increases (and sometimes even a schedule in the plan that lays out future benefit increases), current funding regulations require that only the benefit multiplier in effect in the current plan year can be recognized in calculating the minimum funding standard (Revenue Ruling 77-2). This is a short-sighted approach which contributes to the underfunding problem. Another approach would be to allow the minimum funding amount to be calculated by taking into account expected future benefit increases. This is similar to what is done on salary-related plans where the benefit is related to final average pay. By projecting pay to the years before retirement, the funding is based on expected future benefits.

This is one of the major reasons why hourly and salaried plans for the same employer have different levels of funding.

The funding problem can be exacerbated even further when a decline in contributions occurs to the union-negotiated plan. Contributions are often tied to some measure of production (hours worked, tons of steel produced, etc.). If production (and contributions) decreases, unfunded liabilities can increase in a short period of time.

We suggest that serious consideration be given to changing the regulations on minimum funding of non-salary related plans to allow for expected future benefit increases. This will allow funding to occur on a more orderly basis and will recognize the expected benefit in effect when each person retires.

The Administration's proposals for minimum funding are built around the concept of a "funded ratio". The ratio is the actuarial value of plan assets to 110% of the plan termination liabilities. We would like to know what basis was used to arrive at the 110% figure. As enrolled actuaries, we would like to offer our expertise to you and your staff to judge the method used to determine the adequacy of this ratio. The plan termination liability is also based on all fixed and contingent benefits as if the plan had sufficient assets. This is a much more stringent test than present law requires. We see no justification for this.

It is likely that once a plan reaches the 100% funded ratio, it will try to adopt an investment approach that will maintain that funding level. Another way of saying this is that the sponsor will invest in assets that correlate with the plan termination liability. This means fixed income investments and less use of ownership investments like common stock, real estate, etc. This more conservative investment policy may not be in the best long-run interest of plan participants. Plans with less than a 100% funded ratio may be encouraged towards higher-risk investments to achieve higher returns. This is also not in the interest of the plan participants.

The amortization period for the unfunded accrued liability is tied to the maturity of the plan's liabilities. Is this to be tried up every year? Or only when events such as benefit increases occur?

This shorter amortization period will be especially difficult for new plans. Changes to tax laws -- in particular the change in the Tax Reform Act to pro-rate the Section 415 limit over years of plan participation -- limit the effect of counting past service. We would suggest that the amortization period for new plans be no shorter than ten years.

We believe the changes in handling for waived contributions are reasonable as drafted.

The cash flow rules are an example of a rule that will add confusion for some plan sponsors. Current funding methods allow the employer to have a reasonably level and budgetable cost each year. The cash flow rules will add volatility to the minimum contribution. New plans will need to be exempted from the rule to avoid very cyclical contributions. Further refinement will be needed to take into account things such as the use of insurance to cover lump sum death benefit payments, purchase of annuities at retirement, lump sum cash retirement benefits, etc. We suggest this rule be seriously reviewed and hopefully eliminated.

The proposal requires that the minimum funding contribution be made on a quarterly basis with a final payment within two and a half months after the close of the plan year. This is again not practical. Before the required contribution can be calculated, it is necessary to gather census data and perform the necessary actuarial calculations. Quite often this takes six months or more to complete. It may be necessary to estimate the quarterly contribution for several quarters. Completion of the actuarial valuation may show that the amounts are in excess of the amount allowed. The Tax Reform Act imposes a 10% excise tax on any contributions that are not deductible.

Finally, the proposal increases the interest rate used to amortize any minimum funding amount which has been waived. Amortizing liabilities at two interest rates (part at the actuarial valuation rate; part at the S&P rate for B rate bonds) is a needless complication. It does not add significantly to benefit security. We hope this provision can be dropped.

Summary on Minimum Funding

The Administration proposal changes the concept of minimum funding to a terminating plan concept. This is a change in tax policy that needs to be recognized.

This will lead to higher contribution levels for many plans -- especially in the early years when there are usually unfunded past service liabilities. This increase will be greatest for plan sponsors least able to afford the increase (such as auto and steel).

We have tried to estimate the cost impact of the new proposal on a handful of small plans (most of the plans have benefit formulas of the dollars times years of service variety). Increases in the minimum funding standard range from very little for mature, salary-related plans to 20-30% for newer plans that are moving towards a fully funded position, to as much as 140% increase for a plan that has frequent benefit increases. The cash flow rule has a significant impact on a couple of these plans because of retirements in the first few years. The cash flow rule causes increases of 240% and 563% on two of the plans in one particular year. This is due to the purchase of annuities by the plan at normal retirement.

We would make these suggestions:

1. Any changes in minimum funding standards should be aimed at the small percentage (2-5%) of plans that are underfunded on a plan termination basis and are likely to remain so. We would like to work with the Congress and the IRS to develop alternatives to current funding regulations to better take into account expected future benefit increases. This will help to put the funding on a sounder basis.
2. The cash flow rule is unworkable as currently written. Emerging liability and projected cash flow analysis done by many EAs provides a far better measure of the adequacy of funding and is less volatile. In any event, it should be modified to take account of insured and lump sum benefits, and the purchase of annuities at retirement.
3. The rules for quarterly contributions do not recognize the amount of time needed to gather data and perform the actuarial calculations. It will not add to benefit security, but will result in situations where the estimated contributions turn out to be in excess of the allowed maximum, triggering a penalty tax.
4. The rules on controlled group liability are complicated and will add to the difficulty of trying to maintain defined benefit plans. We would like to explore with the Congress other ideas (such as the maintenance of a single plan for the controlled group with varying benefit schedules) that we believe are more workable and will level out the funding among different employers in the controlled group.

Termination of Underfunded Plans

Strengthening of the minimum funding standards will have a favorable impact on the burden now felt by the PBGC. It may be premature to make changes to the definitions of plan termination liability until the new minimum funding rules have had a chance to address any underfunding problems.

We understand that the PBGC plans to unveil its proposal for a risk-related premium soon (at the April 7 hearing). Any analysis of the proposal will need to wait until we have further information. We would like to review the financial information that was used to develop the range of the risk-related premium (from \$8.50 to \$100 per person -- and even higher if a minimum funding waiver is in effect). Did this work take into account contemplated changes in the minimum funding standards? If so, would the risk-related premium be using current minimum funding rules?

While we have no position on the appropriate level of the PBGC premium or the need for a risk-related premium, this is one of only several ways to deal with the financial burden of the PBGC. Other approaches include:

1. Changing the five year phase-in rule for benefit increases. Having benefit increases phased in over five years, with the shortest period for funding those benefits being over ten years, will increase the PBGC's exposure.
2. Reduce the limit on the PBGC's maximum guaranteed benefit. The limit on guaranteed benefits has been indexed upward from \$750 per month in 1974 to \$1,857.75 per month today. The Section 415 limit (the limit on the maximum benefit payable under a qualified plan) has been changed from \$75,000 in 1974 to \$90,000 today. Thus, the PBGC is guaranteeing a much greater percentage of the total allowable benefit today than 1974.
3. Change the definition of distress termination. As an example, distress terminations might only be allowed for an employer who must liquidate a business under Chapter 7 of the Bankruptcy Code.
4. Improve the standing of the PBGC as a creditor in bankruptcy situations.

Conclusions

The stated goals of the proposal are to encourage optimal funding of defined benefit plans and improve benefit security to employees. We support these goals.

However, many aspects of the proposal do not add to benefit security. In fact, some provisions seem to reduce benefit security (no 100% vesting on asset withdrawal, no defined benefit plans for five years if you exit the system, assets transferred from plans that are overfunded on a termination basis, etc.).

We believe the Implementation Guidelines issued in May 1984 are doing a good job of balancing employee benefit security with employer flexibility. We have seen no evidence that these Guidelines have resulted in the loss of benefits to employees covered by plans that use a spinoff/termination or termination/re-establishment.

The portions of the proposal dealing with the cash flow rule and the need for quarterly contributions should be dropped or, at a minimum, changed significantly.

Finally, any proposals to change the liability at plan termination should recognize the change in minimum funding standards. It will take several years for any new standards to have an effect. Other approaches for dealing with the PBGC's financial burden should be considered.

We appreciate the opportunity to share these thoughts with you. We believe our private pension system -- while there have been some problems -- is on balance a great success. We would like to work with the Congress, Treasury and IRS to develop sound and practical rules for fixing the problems without putting an additional burden on financially sound plans.

Thank you for considering our views.

Mr. FLIPPO. Thank you, Mr. Zimpleman.
Mr. Burrows.

STATEMENT OF EDWARD E. BURROWS, MEMBER, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN SOCIETY OF PENSION ACTUARIES

Mr. BURROWS. Thank you, Mr. Chairman.

ASPA members provide service to about 30 percent of the Nations qualified retirement plans. This makes us vitally interested in the administration's proposals. We believe the proposals reflect a thoughtful approach to problems urgently needing correction, but we recommend modifications. In our written testimony we provide detail respecting these modifications. We outline our objections to the proposals as they stand now.

We offer alternatives we believe will solve the existing problems without bringing on new ones. We hope our counter-proposals will be taken seriously. A knee jerk reaction might be to construe our views as biased in favor of private plan sponsors. We have taken pains to avoid this bias. Our only bias, if bias it be, is a bias favoring survival of the voluntary private pension system. And make no mistake, the voluntary defined benefit pension plan is an endangered species.

Rightly or wrongly private employers have concluded the climate in Washington is not good for defined benefit plans. Those who have plans are postponing improvements. Those who don't have them are not adopting them.

Try this: First induce someone to make a commitment, any commitment based on an agreed set of rules. Then change the rules after the commitment is made. No matter how worthwhile the change might have been, you have a loss of trust. That is what has happened. When it comes to pensions, employers just don't trust Congress right now. They have seen their plans yanked around too much, too often.

We must be absolutely certain any new regulation is obviously and irrefutably necessary for the benefit of the pension system and its covered workers. It must be just as irrefutable that the necessary measures go only as far as they need and not one step further. We must be certain no one can accuse us of overkill. ASPA's counterproposals reflect these imperatives.

One of our most important counterproposals reflects still another imperative. This imperative is that graded or variable rate PBGC premiums be added to the list of administration proposals to be considered as one single package. Graded premiums are necessary as a matter of fairness. They are necessary as a message to sponsors that unaffordable benefits must not be adopted and they are essential to ASPA's counterproposals on asset withdrawal.

Time doesn't permit me to elaborate orally on each counterproposal. It is all covered in our written testimony. But I do want to list our key points.

One, the administration's proposals on safety margins before permissive asset withdrawal are far too restrictive. Provided we have graded PBGC premiums, much smaller margins are highly desirable.

Two, the size of the safety margin should depend on several aspects of the funds asset mix—not just the existence or nonexistence of insurance company annuities.

Three, the proposed rules on frequency of withdrawals during any 10-year period are needlessly restrictive. They will actually encourage unnecessary plan terminations.

Four, the 10-percent asset withdrawal tax should not apply to any withdrawals which will ultimately have to be repaid to the plan. This approach sounds complicated and it is, but the gain is worth the complication. The gain comes in terms of basic fairness. It comes as well in terms of the message transmitted to the private community, Congress wants to protect and nourish the private pension system, not confiscate private property.

Five, the proposal to encourage use of excess pension assets for health care benefits is not intrinsically bad. But it will cause harm if it lulls us into thinking we have solved one of today's most critical employee welfare problems.

We believe the solution to this critical problem requires a major shift in thinking about budgetary deficits.

Six, the administration's proposals to accelerate funding go too far. We recommend replacing them with a new standard. The new standard would supplement the existing one. You would have to satisfy both. We call our standard a projected cash flow test.

I would be happy to answer any questions the committee might have regarding our proposals either now or at a later date. I thank you.

[The prepared statement follows:]

TESTIMONY OF THE AMERICAN SOCIETY OF PENSION ACTUARIES

The American Society of Pension Actuaries (ASPA) is a national professional society of about 2,300 members. Our members provide actuarial, consulting and administrative services to a significant number of private employee benefit programs in the United States. These include about 30% of the nation's qualified retirement plans.

We applaud the administration for its proposals. Each aspect is designed to make corrections where corrections are badly needed. However, there are some areas where we believe the administration's accuracy in identifying problems is not matched by the appropriateness of its proposed corrections.

OVERVIEW

We subscribe fully to the proposals governing investment in employer securities, relaxing contribution deduction limitations, and strengthening standards for non-distress plan terminations. We also subscribe to the proposals expanding employer liability following distress terminations. (We do question whether the expansion will have much effect in view of the distressed nature of the involved sponsors.)

We note with particular enthusiasm the proposal to outlaw ESOP/Defined Benefit floor plan combinations. We believe current practices in this area are detrimental to the strength of the voluntary private retirement plan system.

The proposals for permissive withdrawals from ongoing plans are disappointingly restrictive. If adopted in their proposed form, they would not accomplish their objective of providing incentives to maintain soundly funded defined benefit plans.

Failure to couple withdrawal and funding proposals with a proposal for graded PBGC premiums would be a serious mistake.

The proposal to apply the asset reversion excise tax to ongoing plan withdrawals is inappropriate. This proposal represents an attempt to correct a non-existent ill.

The proposal to provide incentives for post retirement health care funding is worthwhile as far as it goes. However, we are concerned lest it be interpreted by anyone as a solution to a problem.

The proposals for strengthened funding standards are frightening in their severity. In terms of curing an ill, they represent a massive and potentially lethal overdose.

In the material which follows, we develop our position on each point where we find the proposals wanting. We also offer alternatives which we believe will be more effective in meeting the administration's objectives.

We hope that our attention to those points where we see a need for improvement will not be interpreted as lack of enthusiasm for the administration's proposals. The proposals have great merit and deserve to be pursued. We simply point out, here, those places where we believe they need to be improved.

WITHDRAWALS FROM ONGOING PLANS - THE PROPOSED SAFETY MARGIN

The proposals would require that assets remaining in a plan after a withdrawal must equal plan termination liabilities plus a safety margin. Unless annuities are purchased to cover termination liabilities, this margin equals:

- a) 25% of termination liabilities, or, if greater,
- b) The amount by which the full funding liability exceeds termination liabilities. For this purpose, the full funding liability is calculated under the projected unit credit cost method.

In a final pay plan it is not unusual for the full funding liability to exceed termination liabilities by more than 40%. If expected pay increases were particularly steep and expected turnover particularly low, the excess could be far greater.

Employers should be encouraged to fund aggressively with the objective of maintaining assets at least equal to termination liabilities. Those willing to fund against the effect of future pay increases on current accruals should be encouraged to do so. But the inflexible requirement of a buffer which may exceed 40% is not the way to accomplish either objective.

Instead, it is a message to employers that defined benefit plans remain under siege and probably should be avoided where there is a choice. For sponsors who must maintain them, it is a message that funding levels should be kept as low as the law permits.

THE FULL FUNDING LIABILITY AS A MEASUREMENT BASIS

The essence of our problem with the proposed safety margin is its use of the full funding liability as one of the benchmarks. In a pay related plan, this use means a requirement that the safety margin give recognition to future pay increases. ASPA considers it totally inappropriate that mandatory safety margins reflect the impact of possible future pay increases.¹

We are not convinced there has been adequate attention to the nature of the full funding liability as a benchmark in calculating the safety margin. We believe a closer examination will indicate its inappropriateness for this purpose.

An interesting relationship, sometimes found in plans which are not pay related, may help drive home this inappropriateness. In these plans, if nonvested terminations are anticipated, the full funding liability can actually be less than termination liabilities as the terms are defined in the proposals.

IMPACT OF INVESTMENT MIX ON THE SAFETY MARGIN

In establishing safety margins, the administration's proposals make just one distinction reflecting investment mix. This distinction is based entirely on whether or not termination liabilities have been funded through the purchase of commercially insured annuities.

If annuities have been purchased, both of the two proposed safety margin benchmarks are affected:

- a) The percentage of termination liabilities is reduced from 25% to 10%.
- b) The percentage of the amount by which the full funding liability exceeds termination liabilities is reduced from 100% to 40%.

We find this aspect of the administration's proposals lacking in two respects.

First, it is inappropriate to base a distinction related to investment risk on a quantity related almost entirely to expected future pay increases and employee terminations. But this is exactly what is being proposed when it is suggested that the applicable percentage be reduced from 100% to 40%. This suggestion simply makes no sense.

Second, it is not adequate to make just one distinction in discussing the risk of market value fluctuation. There are other portfolio differences at least as important as the distinction between investments which are in the form of annuities and investments which are not.²

Since publication of our 1986 paper on this matter, we have examined, further, the question of investment mix and the appropriate safety margin. We now feel that for most plans, high quality intermediate term fixed income investments should be treated as more secure than cash. This is due to the close correlation between changes in the present value of pension obligations and the market value of intermediate term securities. As interest rates rise, both values will fall. More significantly, as interest rates fall, both values will rise. In contrast, if the fund were entirely in cash, falling interest rates would increase the present value of pension obligations without increasing available resources.

We are continuing our study of these relationships, and expect to make additional recommendations shortly.

1. See pages 23 through 26 of ASPA position paper entitled "Asset Reversions From Defined Benefit Plans" for more details.

2. Ibid., pp. 30-31.

PERMISSIVE WITHDRAWALS AND GRADED PBGC PREMIUMS

The Executive Director of the PBGC is actively promoting a proposal for graded PBGC premiums. ASPA vigorously supports this proposal.

This graded premium proposal was conspicuous by its absence from the February 19 memorandum outlining the administration's other proposals on plan funding and termination. ASPA believes it would be a serious mistake to address the question of withdrawals from ongoing plans without at the same time addressing the question of graded premiums.

There are many reasons why graded premiums make sense. The most important one is fairness. The greatest premium would be paid by those saddling the PBGC with the greatest risk. The next most important one is the disincentive graded premiums would offer to the sponsor considering benefit improvements he cannot afford.

Our principal focus here is the inextricable relationship between withdrawals from ongoing plans and the risk placed on the PBGC.

Without graded premiums, it is difficult to justify permitting withdrawals which could have the slightest possibility of increased risk to the PBGC. A safety margin even greater than the one proposed by the administration might easily be justifiable. This would be particularly true where the approach to investment risk-taking has been aggressive.

ASPA believes the avoidance of large mandatory safety margins is essential to the encouragement of soundly funded defined benefit plans. With graded premiums, it becomes rational to permit withdrawals leaving much smaller safety margins than those of the administration's proposals. The sponsor wishing to avoid funding a safety margin would be free to do so. But that sponsor would be asked to pay the PBGC a greater premium. This premium would reflect the greater risk to the PBGC inherent in the existence of plans without funded safety reserves.

In our view, ongoing plan withdrawals do not make sense without graded premiums. Graded premiums make sense even if such withdrawals are not permitted. But we believe the political viability of graded premiums will be greatly enhanced by linking the proposals.

We urge that graded premiums and ongoing plan withdrawals be placed in a single package. This coupling is at the very heart of the proposals outlined in our 1986 paper.

THE TEN YEAR FREQUENCY LIMITATIONS

The administration's proposals place serious restrictions on multiple withdrawals during any ten year period.

The justification for these restrictions appears to involve the possibility that frequent withdrawals could be undertaken in a manipulative way. The manipulation would involve utilizing investment fluctuations to select against the plan.

We are not impressed with this argument. However we are impressed with the harm which could be caused by the ten year rules. They will cause sponsors to withdraw more than would otherwise be the case "because I only get three chances every ten years."

In extreme cases, the restrictions will cause termination of plans which would otherwise not be terminated. Consider, for example, a sponsor maintaining 60 defined benefit plans. Suppose one of the 60 is to be terminated. The sponsor will be well advised to look around and consider which of the other 59 are potential termination candidates. Suppose there is a possibility that another plan might be terminated within the next ten years. The sponsor is likely to accelerate things and wrap the two terminations into one transaction. This could be the only way to live with the "three in ten years" rule, in a multiple plan environment.

We urge that the ten year frequency limitations be abandoned.

ONGOING PLAN WITHDRAWAL AND THE ASSET REVERSION TAX

The rationale^{*} underlying the 10% excise tax is that it appropriately reverses the tax expenditure of sheltering investment return. This rationale does not justify a tax in cases of withdrawal from ongoing plans where the withdrawn amount will eventually have to be replaced.³

ASPA has raised this issue with those individuals who have been active in formulating the administration's proposals. These individuals point out the difficulty of controlling situations where an ongoing plan withdrawal will ultimately turn out to have been a plan termination reversion.

We acknowledge this difficulty. However, we believe the gain to be realized by developing and administering a solution is worth the effort. A failure to make this effort will leave the system with a funding disincentive. This failure would also violate basic tenets of fairness.

We propose ground rules along these lines:

1. Only those assets which exceed the present value of benefits expected to be paid are subject to the tax.
2. This present value is based on all benefits expected to be paid to current participants. Hence, unless and until a plan is terminated, the present value is not restricted to benefits currently accrued.
3. A look-back provision applies during the five years after an ongoing plan withdrawal. During this period, any termination or curtailment amendment causes a recalculation of benefits expected to be paid. The recalculation occurs as of the date the withdrawal was made. The new calculation reflects the termination or curtailment amendment.
4. If this new calculation shows that assets withdrawn were amounts exceeding the value of benefits expected to be paid, an excise tax is applied retroactively. The tax is the interest adjusted tax which would have been applied if adoption of the amendment had been anticipated.

The complexity of a look-back provision must be evaluated in the context of the complexity of employee benefit legislation in general. It must also be evaluated in the context of the importance of the principles being served: Fairness and the avoidance of funding disincentives. In this light, we would view as disingenuous any suggestion that a look-back is too complicated.

INCENTIVES FOR POST RETIREMENT HEALTH CARE FUNDING

The need for non forfeiture protection covering retired employee health care coverage is becoming increasingly apparent. However, it is also apparent that vesting rules will be worthless without funding, and funding will not occur without incentives. Finally, it is apparent that funding incentives are not viable under the current ground rules covering tax expenditures and deficits.

The problem is enormous and critically important. We believe it calls for a new look at deficits. The look would involve a distinction between deficits related to current consumption and those incurred to encourage the funding of socially desirable future benefits.

We do not find the administration's proposals on post retirement health care funding objectionable as far as they go. But we do harbor great concern that the proposals will be espoused as solutions to a problem. They are not. They are analogous to band-aids for a patient who belongs in an intensive care unit. To the extent these proposals slow down the quest for a real solution, they do a disservice to America's workers.

3. Ibid., p. 19.

FUNDING STANDARDS - SHORTENED AMORTIZATION PERIODS IN GENERAL

The proposal for shortened amortization periods in general is incomplete. Until more information is furnished, evaluation is difficult. Nevertheless, the potential is frightening. In a great many cases, underfunding is directly attributable to financial difficulties of the sponsor. There appears to be great danger that the proposed cure will kill the patient.

The proposed definition of the maturity of a plan's liabilities appears to lend itself to manipulation. Through artful selection of methods and assumptions, the actuary can produce totally acceptable variations in the relationship between accrued liabilities and the present value of expected future benefits. Admittedly, any such manipulation would be partially self defeating. A reduction in the maturity index would go hand in hand with an increase in normal costs. Despite this, there does appear to be an undesirable potential for manipulation.

We suggest an alternative involving a supplementary standard based on projected cash flow. The existing standard would remain in place. The minimum contribution would be the one required by the existing standard or the cash flow standard, whichever is higher. The cash flow standard would require an estimate that the fund will have a positive balance continuously throughout the ensuing ten years if:

1. Contributions in each of these years are at the current year's rate, and
2. Benefit disbursements in each of these years occur at the expected rate.

Each year, a new ten year projection would be required.

We believe many problems involving adherence to nothing more stringent than existing standards would have been avoided if this supplementary standard had been imposed.

FUNDING STANDARDS - THE FUNDED RATIO MAINTENANCE RULE

The proposed funded ratio maintenance rule is operative whenever the funded ratio drops and the new ratio is less than 100%. Under the rule, an element of accrued liability is isolated and made subject to three year amortization.

This rule seems to have the potential for devastating results in the face of any large and uncontrollable experience loss.

We are particularly concerned over the issue of investment losses. We are concerned that the proposed rule would prompt a more conservative investment stance. A long term result could be less effective investment programs. It could also be decreased availability of equity capital for development of the new technology necessary to maintain our nation's competitive position.

The funding maintenance rule could produce equally devastating results in the event of a change in the assumptions prescribed for calculating the Termination Liability. These assumptions could change as the result of a rule tying them to changing market conditions. Or, they could change as the result of regulatory changes. Either way, a sudden increase in Termination Liability could cause a sudden reduction in the Funded Ratio. If the new Funded Ratio were less than 100%, all or part of the reduction would be subject to the 3 year amortization requirement.

We are not convinced that the funded ratio maintenance rule is a good idea. We believe the supplementary cash flow test already described may be sufficient.

FUNDING STANDARDS - THE CASH FLOW RULE

The cash flow rule applies whenever the funded ratio is less than 100%. Under this rule, contributions in a year must be at least as great as disbursements in the same year.

This rule would be particularly difficult for the small sponsor, where cyclical fluctuations in benefit disbursements are likely to be pronounced. It could cause sponsors to place counterproductive restrictions on disbursement options.

One key reason for funding is to immunize the sponsor from the strains of cyclical disbursement fluctuations. It seems strange to tell a sponsor he must fund but cannot take advantage of a key benefit of funding.

We think this proposal needs rethinking. Again, we believe our proposed test involving projected cash flow may be as much remedial action as the situation requires.

THE NEXT STEP

We have set down, here, certain shortcomings we see in the administration's proposals. We have offered alternatives.

We do not suggest that our alternatives are necessarily free of shortcomings.

We do hope our alternatives will receive serious attention. We hope the administration's proposals, our alternatives, and alternatives suggested by others will all be considered, in an attempt to develop the most useful solutions possible.

ASPA is pleased at the opportunity to present its views to the Committee. We are eager to help the Committee and its staff in every way possible, as it pursues its consideration of the administration's proposals. We would welcome requests for assistance at any time.

Respectfully submitted by:

American Society of Pension Actuaries
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By Edward E. Burrows, M.S.P.A., Member of Government Affairs Committee

April 9, 1987

Mr. FLIPPO. Thank you very much for your testimony. Let me ask a question of Mr. Burrows. I get the message from the testimony presented that Congress should not do anything that is not necessary and perhaps we have had a great too many changes in other areas and maybe too much in this one.

Let me ask you if you accept the analysis of GAO and CBO and PBGC that we have an imbalance and that something needs to be done, do you think it is broke? Do you think we need to fix it?

Mr. BURROWS. We think the PBGC needs to be fixed. I have had an opportunity to read Dr. Utgoff's testimony. I consider the proposal that she outlined to be one of the most well conceived proposals I have seen in a long time. We strongly support it and we applaud Dr. Utgoff for that proposal. Our only real objection to the proposal, and it is one we can live with, is that it doesn't go far enough.

In our view, the rate structure should be even more aggressively exposure related than is reflected in Dr. Utgoff's proposal. The \$8.50 basic rate is in our view too high.

Mr. FLIPPO. I believe each of you in your testimony have stated that you do not agree with making these partial payments every three months. I believe that was your testimony. I believe you said that it was too complicated. Help me understand why then is it more complicated than a quarterly estimate on an income tax return?

Mr. ZIMPLEMAN. The primary reason that we believe it is too complicated is that you have to first understand the process of determining both the minimum funding contribution and maximum deductible contribution for a pension plan. The process starts with gathering census data as of the beginning of the plan year and in my own personal experience, quite often just that process of gathering data from the employer can often take as long as three months.

Then in addition to that, of course, there is the time needed to perform the calculations. So it is not unusual to see valuations that are performed sometime during the plan year perhaps the middle of the plan year after the necessary salary and new participant information has been gathered and those people terminated during the year have been recognized and taken out of the census group.

It is different than an estimated tax liability where the tax rates are known, and you can estimate income as you go along and therefore make an accurate estimate. The actuarial valuation process is a different kind of calculation as we see it.

Mr. BURROWS. ASPH does not oppose the proposal provided we have estimating concepts analogous to those now in place for estimated tax payments. ASPH believes the proposal makes a lot of sense. There are too many opportunities for the sponsor to go belly up in the 8½ months after the tax deadline. We would not follow the proposals in one respect. The administration uses the concept of a funded ratio. Our belief is that any plan with a funded ratio of 100 percent or more should be relieved from the necessity of making advance contributions during the year.

Mr. FLIPPO. I see. The administration's proposal on the variable rate, what specific problems does that present to you as actuaries?

Mr. BURROWS. I will respond first. I think you already know that ASPH strongly and aggressively favors the variable rate proposal. It is a little more work but it is a little work well worth the effort. The gain certainly justifies the effort.

Mr. ZIMPLEMAN. I would essentially concur with that. I think the proposal as it is constructed now has eased the difficulty of making the calculations that were earlier versions where it would be quite difficult but I believe most of those objections have been overcome.

Mr. FLIPPO. Mr. Zimpleman, in your remarks you stated I believe that a cushion is unnecessary because plans service credit is seldom granted when defined benefit plans are reestablished following an asset reversion termination.

Doesn't this failure to grant past service credit in the new plan cause employees a substantial loss in their expected final benefits?

Mr. ZIMPLEMAN. It does cause some diminishment, in the ultimate benefit at retirement, you are correct. In fact one of the last times we were here to testify a couple of years ago dealing with the needs for national retirement income policy we pointed out that for the worker who transfers or who changes jobs several times during their career ends up with a benefit at retirement that will not be as great as one who stays with the same employer for their whole career assuming they are final salary pension plans. So, yes, there probably is some loss there but I am not sure that that loss is in any way shape or form made up by the granting of past service credit.

The loss you refer to is really a loss because of the failure to recognize the final average salary.

Mr. FLIPPO. Gentlemen, Mr. Anthony is here. Would you have questions?

Mr. ANTHONY. I have no questions, Mr. Chairman.

Mr. FLIPPO. We appreciate your testimony. It is helpful to us and we will examine it in greater detail.

Thank you.

Our next panel today, we have the Employee Stock Options Association of America, Mr. Kaplan, chairman of the Legislative and Regulatory Advisory Committee, and we have Norman Stein, the visiting professor of law, University of Texas Law School.

We appreciate your being with us today. We will include your testimony in full in the record and since we are in session we would ask you summarize so that our panel may have an opportunity for questions. Thank you for being with us and please proceed.

STATEMENT OF JARED KAPLAN, CHAIRMAN, LEGISLATIVE AND REGULATORY ADVISORY COMMITTEE, EMPLOYEE STOCK OWNERSHIP PLAN ASSOCIATION OF AMERICA

Mr. KAPLAN. Mr. Chairman, my name is Jared Kaplan, a partner in the law firm of Keck, Mahin & Cate in Chicago, Ill.

I am chairman of the ESOP Association's Legislative and Regulatory Advisory Committee. My statement today is made on behalf of the ESOP Association which is a national nonprofit organization with approximately 1,000 members consisting of both companies with ESOPs and firms that provide services to the ESOP companies.

We realize that the ESOP related provisions of the administration's defined benefit proposal are relatively minor when viewed in the context of the overall proposal but we feel that the administration's proposal contains negative ESOP provisions that we must speak out on at this negative albeit minor attack on ESOPs and employer ownership.

The proposal would limit the acquisition and holding of employer's securities with respect to four offset arrangements as follows: first, the individual account plan portion of a floor offset arrangement would be made subject to the 10-percent limitation on acquisitions of qualifying employer securities and second, existing investments in qualifying employer securities by the individual account portion of the arrangement in excess of 10 percent of plan assets would be permitted for a specified period under rules similar to those in section 407 ERISA.

The underlying reason for the proposal in these respects is the theory that if an ESOP constitutes the individual account portion of the floor offset arrangement the security of participants defined benefit program is substantially weakened and the risk of loss to the PBGC is thought to be increased.

The perceived problem in this instance may be more imagined than real. The ESOP association has indicated that of its more than 500 regular members, only 5 have offset arrangements; 1 percent. While not every ESOP employer is a member of the association this is certainly a representative sample.

My statement today is made on behalf of the ESOP Association. The Employee Stock Owners Plan Association is a national, non-profit organization with approximately 1,000 members. The association's regular members are companies with employee stockowners plans, and associate members are those individuals and firms that provide services to employee stockowners plan companies.

Mr. Chairman, I would be remiss if I did not stray from the exact purpose of my statement to say something nice about you. I hope I have your permission to express once again, publicly, the sincere admiration and appreciation for the leadership role that you have taken on employee stock owners plans in general.

The Employee Stock Owners Plan Association, and the thousands and thousands of supporters of employee ownership still recall fondly the Anthony Employee Stock Owners Plan amendment of 1985 that saved employee stock owners plans from some negative proposals that would have stopped the growth of employee stockowners plans.

And, for the public record, I note that your remarks in the Congressional Record of October 25, 1986, explaining the employee stockowners plan provisions of the Tax Reform Act of 1986 and how those provisions were developed, have become very influential in the world of employee stockowners plans. Since I am from Chicago, on a parochial note, I add that Chairman Rostenkowski's remarks on employee stockowners plans that day are also considered very key to understanding employee stockowners plan law.

Turning to the specific purpose of today's hearing, we of the Employee Stock Owners Plan Association realize that the employee stockowners plan related provisions of the administration's defined

benefit proposal are relatively minor when viewed in the context of the overall proposal.

In other words, our statement today will be brief, as we recognize that the employee stockowners plan tail cannot wag the administration's defined benefit dog.

We feel, however, the administration's proposal contains negative employee stockowners plan provisions, and we must speak out against this negative, albeit minor, attack on employee stockowners plans and employee ownership.

The proposal would limit the acquisition and holding of employer securities with respect to floor offset arrangements as follow:

First, the individual account plan portion of floor offset arrangement would be subject to the 10-percent limitation on acquisitions of qualifying employer securities.

Second, existing investments in qualifying employer securities by the individual account portion of the arrangement excess of 10 percent of plan assets would be permitted for a specified period under rules similar to those in section 407(a) of ERISA.

The administration's stated reason for its proposal is that if an employee stockowners plan constitutes the individual account portion of the floor offset arrangement, the security of participants' defined benefit promise is substantially weakened and the risk of loss to the PBGC is greatly increased.

The perceived problem in this instance may be more imagined than real: the Employee Stock Owners Association has indicated that, of its more than 500 regular members only 5 have floor offset arrangements. While not every employee stockowners plan employer is a member of the Employee Stock Owners Association, this is certainly a representative sample.

The proposal concentrates on the down side risk only—floor offset arrangements using employee stockowners plans also give participants the opportunity to realize greater retirement benefits than the defined benefit plan can provide. Furthermore, where an employer has an existing defined benefit plan and uses an employee stock owners plan to buy out a current shareholder, the use of the floor offset arrangement or prospective accruals can preserve employee's pension expectations. In that instance, if a floor-offset arrangement utilizing the employee stockowners plan cannot be used, the defined benefit plan will likely be terminated or frozen because of cash flow requirements.

Finally, the divestiture of employer securities to comply with the 10-percent limitation, even over a transition period, may cause great difficulty for a closely held employer which may have to simultaneously repurchase shares at appraised fair market value and provide funding under the defined benefit plan.

We oppose the administration's proposal.

Because the Employee Stock Ownership Association concerns about the floor-offset plan liabilities being dumped on PBGC are serious theoretical concerns, we will explore with your staff various ideas to minimize the risk to the PBGC.

For example, in testimony to the House and Senate Labor Committees, the National Association of Manufacturers suggested additional premium payments to the PBGC instead of an out and out prohibition on floor-offset plans. Other ideas may be a different

funding standard, conservative funding guidelines, or no funding waivers for such plans.

At this time we have no specific set of amendments to the proposal, but we want to work with Congress and the administration on any reasonable requirements for sponsors of floor-offset arrangements.

We also believe that a key provision of the Anthony employee stockowners plans amendment protects employees in a floor-offset arrangement. We refer to the new diversification rule all employee stockowners plans must meet. This rule allows employees to diversify their employee stockowners plans accounts from employer stock as they near retirement.

In sum, we ask the committee to reject the administration's floor-offset proposal because:

First, its fear of unfunded liabilities from existing floor-offset plans being dumped on the PBGC are unfounded.

Second, the Anthony employee stockowners plan amendment's diversification requirement provides protection to employee stockowners plan participants of a floor-offset arrangement.

Third, it is basically unfair, and economically unsound, to force termination of existing floor-offset plans.

Now, Mr. Chairman, I turn to an area that is unclear in the administration's proposal. It is an area that directly relates to legislation, H.R. 41, which you have introduced.

To explain, the Tax Reform Act of 1986 enacted new code section 4980, which provides generally that the surplus amounts from a terminated defined benefit plan were subject to the regular corporate tax plus a 10-percent excise tax. But code section 4980(c)(3) was adopted by the Senate Finance Committee in its version of tax reform on the motion of Senator Max Baucus. The House version of tax reform did not contain this employee stockowners plan provision.

House-Senate conference committee retained the Baucus amendment, but provided for it to expire as of January 1, 1989.

The administration's proposal before you states that all allowed asset withdrawals, and all surplus assets reverting to an employer, would be subject to the ten percent excise tax and the income tax, except for those amounts transferred to fund a plan providing health benefits to current retirees.

Furthermore, the administration's proposal provides for an effective date of January 1, 1987, and implies some changes may be applied retroactively.

If the intent of these provisions is to repeal the Baucus amendment 1 year early, we express our strong opposition to any such intent.

In fact, the Employee Stock Ownership Association is a strong supporter of the Anthony bill, H.R. 41, which among other things, would make the Baucus amendment a permanent part of the code.

We oppose the repeal of the Baucus amendment because:

First, as Senator Packwood generally commented when the Baucus amendment was proposed, transferring the surplus away from the employer back to the employee is a positive thing, and should be encouraged.

Second, the Baucus amendment has resulted in several large, publicly traded corporations sharing ownership with employees. The Employee Stock Owners Association is well aware that if employee stockowners plans are ever going to break the objectionable concentration of wealth in America, there will have to be more employee ownership of large corporations.

We look forward to continuing to work with you, Mr. Chairman, and your staff.

Thank you very much. I would be happy to answer any questions.

Mr. FLIPPO. Thank you for your testimony.

Before our next witness testifies, let me correct the statement that I made initially. I said that he was associated with the University of Texas Law School and I am delighted to see that he is associate professor at the distinguished law school at the University of Alabama, so I am pleased to correct that, and pleased to know your visit in Austin, Texas, which is our full committee/subcommittee Chair's area—only a temporary nature. Be delighted to have your testimony.

STATEMENT OF NORMAN P. STEIN, VISITING PROFESSOR OF LAW, UNIVERSITY OF TEXAS LAW SCHOOL, AND ASSOCIATE PROFESSOR, UNIVERSITY OF ALABAMA SCHOOL OF LAW

Mr. STEIN. Mr. Chairman, and members of the committee, my name is Norman Stein. My principal teaching and research interests are federal taxation and deferred compensation. Before I began teaching, I practiced tax and pension law in Washington, DC, and Atlanta, GA.

Pension plan reversions raise issues of both pension and tax policy. From the perspective of pension policy and employer's recovery of plan assets can frustrate the benefit expectations of employees and all but eliminate the possibility of ad hoc benefit increases for retirees. A policy that permits asset recoveries at such a cost is a policy that turns a blind and sometimes vicious eye to the needs of our elderly.

Today, though, I prefer to focus on some of the tax policy issues raised by reversions. I do so not because I view issues of pension policy as less significant; I do not. Ultimately, the goals of the tax pension provisions and a humane retirement system should be the same: providing working men and women with the promise of a financially secure and dignified old age.

I focus on the tax aspects of section 401(a)(2) because they have not received the same attention as the retirement policy issues and consequently, are not as well understood. My oral testimony will focus on two issues: first, the meaning of the term "erroneous actuarial computation" as it is used in Treasury regulations; and second, the possible tax subsidy to employers who recover reversions, even after the introduction of the 10-percent excise tax. The Tax Code's treatment of reversions begins with section 401(a)(2) and Treasury regulation 1.401-2(b), which interprets it. This section requires a qualified pension trust to provide that prior to the satisfaction of all liabilities with respect to employees and their beneficiaries it must be impossible for any part of the corpus or

income to be used for, or diverted to, purposes other than for the exclusive benefit of the employees or their beneficiaries. The regulations, in turn, state that the intent and purpose of section 401(a)(2) "is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, such balance in the trust as is due to erroneous actuarial computations during the previous life of the trust."

The IRS apparently understands the cited code and regulatory provisions to have as their more or less exclusive purpose the protection of employee accrued benefits. History, though, demonstrates that these sections were to serve another purpose as well: to preclude employers from deducting contributions to pension trusts in which the employer retained important rights to the trust assets, rights that made the assets property that had not been sufficiently dedicated to pension purposes.

The predecessor to section 401(a)(2) was added to the tax law by the Revenue Act of 1938. The language crafted by Congress in 1938 has remained a part of our tax law through the intervening half century. To understand why Congress first enacted what is now section 401(a)(2) we need to understand something of what came before.

Prior to 1938 the tax laws had permitted employers to deduct contributions to revocable pension trusts and terminate them at will at some later date. At the time, state law generally defined participant rights to accrued benefits as either gifts that could be canceled by the employer at will or unilateral contract rights that vested only when an employee retired from the employer after a specified age. This could, of course, be altered by express plan language, but this was rare. Since there would be few, if any, employees with vested rights in their accrued benefits, an employer who terminated a pension plan often could recover all or almost all of the plan's assets.

In the 1920's, the Bureau of Internal Revenue had argued in several cases before the Board of Tax appeals that the tax laws prohibited employers from deducting contributions to a revocable pension trust. The Board rejected these arguments, and in 1929 regulations were promulgated that permitted an employer to deduct contributions to a pension trust, even though revocable, provided that the "trust is of such character so as to evidence good faith on the part of the employer actually to pay the amounts trustee for employees' pension purposes." If an employer did revoke a trust and recover plan assets, the employer would have been required to include the recovered assets as income in the year of recovery.

From the employer's standpoint, the discretion to terminate a pension trust must have been an important tax planning tool, since the tax laws made no provision for the deduction of net operating losses for much of the 1930's. So, for example, if an employer had a net operating loss for a year, it would have considered terminating its pension plan to recover the assets and create income to absorb the loss.

In 1937, following a Presidential statement and hearing on various methods of tax abuse, including tax motivated pension manipulation, a House Ways and Means subcommittee began to study

ideas for revising the tax laws. One of the subcommittee's concerns was the revocable pension trust:

A special method of taxation is provided for such a pension trust . . . There is no requirement at present that the trust be irrevocable. It is evident, however, that the employer should not be allowed a deduction for amounts which are still within his control, and subject to recapture, through a power to revoke the pension trust.

The subcommittee proposed requiring the irrevocability of a pension trust as a condition for status as a qualified plan. The House version of the Revenue Act of 1938 followed this recommendation: it would have amended the predecessor to section 401(a)(2) to include the following language:

* * * Under the trust instrument it must be impossible for any part of the corpus or income to be within the taxable year or thereafter used for, or diverted to, purposes other than for the exclusive benefits of the employees.

This language would have made it impossible for plan assets to revert to the employer on termination or before.

While the report of the House subcommittee noted that its proposed amendment would encourage "the formation of pension trusts upon which employees can rely with assurance for support upon retirement," the amendment was designed to prevent employers from deducting contributions to trusts that in many respects were simply segregated funds of the corporation.

The Senate Finance Committee, apparently in response to employer lobbying, made a change to the House bill which it "deemed advisable in fairness to the employers."

The Senate Finance Committee explained its change as follows:

* * * It is quite possible that after satisfaction of all pension liability under the trust, an additional amount of funds of the trust will remain, due to erroneous actuarial computations during the previous life of the trust. It seems desirable to allow the employer to provide for the return of such an amount in the trust without the trust losing its exempt status under Section 401(a)(2).

The Senate, by its adoption of the House bill with the one modification, accepted the basic House premise that an employer should not be able to deduct contributions to a pension plan and then treat those contributions and interest thereon as recoverable employer property.

The Senate's modification, however, suggested that the Senate believed there would be no tax abuse if after a plan satisfied its benefit liabilities it paid the employer any remaining assets that were due to previous mistakes made by the plan's actuary in computing plan contributions. The Senate's modification was accepted by the House at conference and the predecessor to section 401(a)(2) thus became a part of the tax law.

In 1939 Treasury regulations interpreting the predecessor to section 401(a)(2) were first promulgated. These regulations provided that

* * * The report of the Senate Committee on Finance * * * states the intent and purpose of the section was to permit the employer to reserve the right to recover only such balance in the trust at its termination as is due to erroneous actuarial computations during the previous life of the trust.

The regulations proceeded by definition and example, to limit the meaning of actuarial error to mispredictions of mortality and perhaps where there were mispredictions of mortality to mispredictions of certain other factors as well. Since actuaries predict things

other than mortality, these regulations were almost certainly incorrect if they meant what they seemed to say.

In 1943, new regulations were promulgated that provided that

* * * A balance due to an erroneous actuarial computation is the surplus arising because actual requirements differ from the expected requirements based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan in accordance with reasonable assumptions as to mortality, interest, et cetera, and correct procedures relating to the method of funding.

Under this regulatory definition of erroneous actuarial computation, an employer would be entitled to recover excess assets that arise because the plan's experience was more favorable than the actuary had predicted. How else could surplus assets arise? An example in the regulations states that surplus assets would not be due to actuarial error if they accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan.

An example with important consequences to employees is the actuary's assumptions in a final pay plan. Such plans typically express benefits in the form of years of service multiplied by a percentage of final pay. Assume, for example, a pension plan that promises employees an annual retirement benefit, beginning at age 65, of 2 percent of final pay for each year of plan participation. Ellen, a 35-year-old employee, is earning \$35,000 per annum. Thus, if Ellen has 10 years of plan participation, she has earned a benefit equal to 20 percent of final pay.

Ellen, no doubt, expects her benefit to be based on compensation in excess of the \$35,000 she is now earning, since she expects her final pay to be considerably higher. As important to the concerns of tax policy, so does the actuary: in most plans, the employer will make plan contributions that are large enough to fund benefits based on employee final pay as projected by the plan's actuary. In the case of Ellen, then, the employer should have contributed an amount to the plan which in 30 years time will, with investment growth, be sufficient to pay her annual benefit of 20 percent times her projected final pay.

When Ellen's employer terminates the plan, however, the law permits the employer to satisfy her benefits by purchasing an annuity contract to pay her an annual benefit at retirement of 20 percent of \$35,000, her current compensation, rather than her projected final pay. As a result, the plan will have excess assets not because of any error the actuary made, but because of sharply reduced benefit obligations compared to those which were being funded. This is so, despite the fact that the actuary's predictions about final pay may turn out to be perfectly prescient if judged against Ellen's pay at the end of her employment rather than her pay at the termination of the plan.

The only error, then, that the actuary actually made was in assuming that the plan would continue. This should not be considered actuarial error.

Van Orman v. Fireman's Fund Insurance Company, is the only case I am aware of to directly consider whether the actuary's failure to consider the possibility of a plan's premature termination was an actuarial error. In that case, the employer argued that the actuary had made an implicit assumption that the plan would con-

tinue and that future events had made this assumption an actuarial error.

The district court, in a 1980 opinion that proved frighteningly insightful, rejected the employer's argument.

The nature of actuarial prediction is such that an ongoing plan must be assumed. Reasonably accurate estimations must be predicted upon events and economic conditions many years in the future. If all that need be shown in order for an employer to recover such a "surplus" is that this expectation was not fulfilled, there would rarely, if ever, be a situation in which the surplus did not arise due to "erroneous actuarial computation." If that were the case, and employer would have a substantial financial incentive to arbitrarily effect a premature suspension or termination of a pension plan. I am certain that Treasury regulation section 1.401-2(b) was not intended to provide that incentive.

The IRS has nevertheless interpreted the Treasury regulation to mean precisely that. I would suggest that the Service's adoption of this interpretation is at odds with a significant legislative intent in enacting code section 401(a)(2): to prevent employers from taking actions that create rather than merely recover surplus assets. Precluding recovery of surplus assets created by the employer's action is as sound a policy today as it was in 1938 and is deserving of legislative reinvigoration.

I would like to turn now to the tax subsidies embedded in reversions.

Current law imposes a 10-percent nondeductible excise tax on plan reversions. Although this tax is often viewed by employers as a penalty tax, it is in fact intended to recover the substantial tax advantage embedded in revertible assets. The tax advantage arises because contributions to the pension plan, and the investment return thereon, are not taxed until distributed, either to a participant as a benefit or to the plan sponsor as a reversion.

Reversions should be taxed sufficiently that an employer who receives a reversion will not, after paying tax, be in a better position than an employer who had not funded a plan surplus but rather had retained the portion of the contribution that would have funded the surplus, paid tax on the retained portion of the contribution, and then invested the after tax amount in currently taxed investments. The 10-percent excise tax is a rough attempt to equalize the position of the two employers.

In many plausible situation, however, the 10-percent excise tax is not sufficient to recover the tax advantages reflected in the reversion. Legislation is needed to correct this flaw, which encourages employers to view pension plans in part as corporate savings accounts.

A related problem is that an employer effectively can realize the value of excess assets not only by terminating a plan and recovering a reversion, but by continuing the plan and reducing contributions to reflect the excess assets. In fact, an employer who continues to plan will realize a greater tax benefit than the employer who terminates a plan, recovers plan assets and pays tax. This is because the excess is not subject to immediate tax and continues to earn interest on a tax deferred basis. Some thought should be given

to whether plans with excess assets above a certain level should be required to dedicate those assets to benefit improvements or else to subject to some excise tax.

Thank you.

[The prepared statement follows:]

Statement of Norman P. Stein, Associate Professor, University of Alabama School of Law

Mr. Chairman and Members of the Committee. My name is Norman P. Stein. I am an Associate Professor at the University of Alabama School of Law. This past semester it has been my pleasure to have been a Visiting Professor at the University of Texas School of Law in Austin. My principal teaching and research interests are federal taxation and deferred compensation. Before I began teaching I practiced tax and pension law in Washington, D.C. and Atlanta, Georgia.

Pension plan reversions raise issues of both pension and tax policy. From the perspective of pension policy an employer's recovery of plan assets can frustrate the benefit expectations of employees and all but eliminate the possibility of ad hoc benefit increases for retirees. A policy that permits asset recoveries at such a cost is a policy that turns a blind and sometimes vicious eye to the needs of our elderly.

Today, though, I prefer to focus on some of the tax policy issues raised by reversions. I do so not because I view issues of pension policy as less significant; I do not. Ultimately the goals of the tax pension provisions and a humane retirement system should be the same: providing working men and women with the promise of a financially secure and dignified old age. I focus on the tax aspects of reversions because they have not received the same attention as the retirement policy issues and consequently are not as well understood.

My testimony discusses, first, the historical origins and meaning of the tax provisions relating to reversions and how the current administration's interpretation of those provisions has swerved off course; second, the inadequacy in many cases of the current ten percent excise-tax on reversions to recover the embedded tax advantage in a reversion; and third, the problems in the Administration's proposals insofar as they concern reversions from overfunded plans.

A. Meaning of term "erroneous actuarial computations"

The tax Code's treatment of reversions begins with section 401(a)(2) and Treas. Reg. § 1.401-2(b), which interprets it. Section 401(a)(2) requires a qualified pension trust to provide that "prior to the satisfaction of all liabilities with respect to employees and their beneficiaries [it must be impossible] for any part of the corpus or income to be used for, or diverted to, purposes other than for the exclusive benefit of [the] employees or their beneficiaries." Treas. Reg. § 401-2(b), in turn, states that the "intent and purpose" of section 401(a)(2) "is to permit the employer to reserve the right to recover at the termination of the trust, and only at such termination, such balance in the trust as is due to erroneous actuarial computations during the previous life of the trust."

The Internal Revenue Service apparently understands the cited Code and regulatory provisions to have as their purpose the protection of employee accrued benefits. History, though, demonstrates that these sections were to serve another purpose as well: to preclude employers from deducting contributions to pension trusts in which the employer retained important rights to the trust assets, rights that made the assets property that had not been sufficiently dedicated to pension purposes.

The predecessor to section 401(a)(2) was added to the tax law by the Revenue Act of 1938; the language crafted by Congress in 1938 has remained a part of our tax law through the

intervening half century. To understand why Congress first enacted what is now section 401(a)(2) we need to understand something of what came before.

Prior to 1938 the tax laws had permitted employers to deduct contributions to revocable pension trusts and terminate them at will at some later date. At the time, state law generally defined participant rights to accrued benefits as either gifts that could be cancelled by the employer at will or unilateral contract rights that vested only when an employee retired from the employer after a specified age. (This could, of course, be altered by express plan language, but this was rare.) Since there would be few if any employees with vested rights in their accrued benefits, an employer who terminated a pension plan often could recover all or almost all of the plan's assets.

In the 1920s the Bureau of Internal Revenue had argued in several cases before the Board of Tax Appeals that the tax laws prohibited employers from deducting contributions to a revocable pension trust. The Board rejected these arguments, and in 1929 regulations were promulgated that permitted an employer to deduct contributions to a pension trust, even though revocable, provided that the "trust is of such character so as to evidence good faith on the part of the employer actually to pay the amounts trustee for employees' pension purposes." If an employer did revoke a trust and recover plan assets, the employer would have been required to include the recovered assets as income in the year of recovery.

From the employer's standpoint, the discretion to terminate a pension trust must have been an important tax-planning tool since the revenue laws made no provision between 1933 and 1939 for the deduction of net operating losses. So, for example, if an employer had a net operating loss for a year, it would have considered terminating its pension plan to recover the assets and create income to absorb the loss.

In 1937, following a Presidential statement and hearing on various methods of tax abuse, including tax-motivated pension manipulation, the House Ways and Means Subcommittee began to study ideas for revising the tax laws. One of the subcommittee's concerns was the revocable pension trust:

A special method of taxation is provided for such a [pension] trust. . . . There is no requirement at present that the trust be irrevocable. It is evident, however, that the employer should not be allowed a deduction for amounts which are still within his control, and subject to recapture, through a power to revoke the pension trust.

The subcommittee proposed requiring the irrevocability of a pension trust as a condition for status as a qualified plan. The House version of the Revenue Act of 1938 followed this recommendation; it would have amended the predecessor to section 401 to include the following language:

. . . under the trust instrument it [must be] impossible for any part of the corpus or income to be within the taxable year or thereafter used for, or diverted to, purposes other than for the exclusive benefit of [the] employees.

This language would have made it impossible for plan assets to revert to the employer on termination (or before).

While the report of the House subcommittee noted that its proposed amendment had as one of its purposes the encouragement of "the formation of pension trusts upon which employees can rely with assurance for support upon retirement," the amendment was designed to prevent employers from deducting contributions to trusts that in many respects were simply segregated funds of the corporation.

The Senate Finance Committee, apparently in response to employer lobbying, made a "change [to the House bill] which is deemed advisable in fairness to the employers." Where the House bill would have made diversion impossible, the language in the Senate bill made diversion "impossible at any time prior to the satisfaction of all liabilities with respect to employees under the trust."

The Senate Finance Committee explained the provision:

... it is quite possible that after satisfaction of all pension liability under the trust, an additional amount of funds of the trust will remain, due to erroneous actuarial computations during the previous life of the trust. It seems desirable to allow the employer to provide for the return of such an amount in the trust without the trust losing its exempt status under section [401(a)(2)].

The Senate, by its adoption of the House bill with the one modification, accepted the basic House premise that an employer should not be able to deduct contributions to a pension trust while retaining the right to recover them at will. The Senate, though, believed that a contribution could be sufficiently dedicated to pension purposes to support a deduction even though the employer reserved a limited right to recover excess trust assets. However, the right had to be limited to the recovery of excess assets attributable to actuarial errors made by the plan's actuary in calculating the size of contributions during the trust's former life.

The Senate's modification was accepted by the House at conference and the predecessor to section 401(a)(2) thus became a part of the tax law. In 1939 Treasury promulgated regulations interpreting the predecessor to section 401(a)(2). These regulations provided that "[t]he report of the Senate Committee on Finance . . . states the intent and purpose of section [401(a)(2)] was to permit the employer to reserve the right to recover only such balance in the trust at its termination as is due to erroneous actuarial computations during the previous life of the trust." The regulations proceeded, by definition and example, to limit the meaning of actuarial error to miscalculations of mortality (and perhaps to certain other actuarial miscalculations if they coincided with miscalculation of mortality.)¹ Since actuaries predict things other than mortality, these regulations were almost certainly incorrect if they meant what they seemed to say.

In 1943 new regulations were promulgated that provided that "a balance due to an 'erroneous actuarial computation' is the surplus arising because actual requirements differ from the expected requirements based upon previous actuarial valuations of liabilities or determinations of costs of providing pension benefits under the plan in accordance with reasonable assumptions as to mortality, interest, etc., and correct procedures relating to the method of funding."

Under this regulatory definition of erroneous actuarial computation, an employer would be entitled to recover those excess assets that arise because the plan's experience was more favorable than the actuary had predicted. Excess assets can arise in other ways, though. An example in the regulations states that surplus assets would not be due to actuarial error if they "accumulated as a result of a change in the benefit provisions or in the eligibility requirements of the plan."

The Internal Revenue Service apparently believes that except for surplus accumulated because of either of these two reasons, all assets that remain after a plan satisfies its liabilities are due to actuarial error and can therefore be recovered by the employer.² Plans can, however, accumulate excess assets in still other ways that do not involve actuarial error. Surpluses sometimes arise, for example, because the employer terminates the plan.

An example with important consequences to employees is the actuary's assumptions in a final pay plan. Such plans typically express benefits in the form of years of service multiplied by a percentage of final pay. Assume, for example, a pension plan that promises employees an annual retirement benefit (beginning at age 65) of two percent of final pay for each year of plan participation. Ellen, a 35-year old employee, is earning \$35,000 per annum. Thus, if Ellen has ten years of plan participation she has earned a benefit equal to 20 percent of final pay.

Ellen no doubt expects her benefit to be based on compensation in excess of the \$35,000 she is now earning, since she expects her final pay to be considerably higher. More important to the concerns of tax policy, so does the actuary; in most plans, the employer will make plan contributions that are large enough to fund benefits based on employee final pay as projected by the plan's actuary. In the case of Ellen, then, the employer should have contributed an amount to the plan which in 30 years time will, with investment growth, be sufficient to pay her an annual benefit of 20 percent times her projected final pay.

When Ellen's employer terminates the plan, however, the law permits the employer to satisfy her benefits by purchasing an annuity contract to pay her an annual benefit at retirement of 20 percent of \$35,000, her current compensation rather than her projected final pay. As a result, the plan will have excess assets not because of any error the actuary made, but because of sharply reduced benefit obligations compared to those which were being funded. This is so despite the fact that the actuary's predictions about final pay may turn out to be perfectly prescient if judged against Ellen's pay at the end of her employment rather than her pay at the termination of the plan. The only error, then, that the actuary actually made was in assuming that the plan would continue. This should not be considered actuarial error.³

Van Orman v. Fireman's Fund Insurance Co. considers this question of whether the actuary's failure to consider the possibility of a plan's premature termination was an actuarial error. In that case, the employer had argued that the actuary had made an implicit assumption that the plan would continue and that future events had made this assumption an actuarial error. The district court, in a 1980 opinion that proved frighteningly insightful, rejected the employer's argument:

The nature of actuarial prediction is such that an ongoing plan must be assumed. Reasonably accurate estimations must be predicated upon events and economic conditions many years in the future. If all that need be shown in order for an employer to recover such a "surplus" is that this expectation was not fulfilled, there would rarely, if ever, be a situation in which the surplus did not arise due to "erroneous actuarial computation." If that were the case, an employer would have a substantial financial incentive to arbitrarily effect a premature suspension or termination of a pension plan. I am certain that Treas. Reg. § 1.401-2(b) was not intended to provide that incentive.

The Internal Revenue Service, apparently without much consideration of the purpose of the regulation, now interprets it's language to mean precisely that. The Service's interpretation is at odds with a significant legislative intent in enacting Code section 401(a)(2): to prevent employers from taking actions that create rather than merely recover revertible assets. If an employer can deduct contributions to plans that permit the employer to take such actions, the employer will receive deductions for contributions that are, in fact, merely warehoused in the favorable tax environment of the plan. This is appalling tax policy.⁴

Precluding recovery of surplus assets created by the employer's action is as sound a policy today as it was in 1938 and is deserving of legislative reinvigoration. Reversions, if they are to be tolerated at all, should be limited to surplus assets that are in the plan because of events beyond the employer's control, i.e., surplus that arises because of experience gains.

B. Prohibition of Recovery of Assets from Ongoing Plans

Treasury regulations for over 45 years have provided that employers could not recover plan assets from ongoing pension plans. The purpose of this rule was broader than the two purposes often offered: protection of accrued plan benefits and ensuring the actuarial soundness of the plan's funding vehicle. The rule was also designed to prevent an employer from deducting contributions to a pension plan while reserving the right to recover those contributions for general corporate purposes. The only exception to this was for excess assets that were created by actuarial error, circumstances that were beyond the employer's control.

In the early 1980s employers began to devise means of formally terminating their plans but continuing defined benefit coverage through artifices that came to be known as spinoff terminations and termination/reestablishments. These so-called terminations would have been appropriate targets for application of either the step transaction or substance-over-form doctrines.

In fact, in 1983 Treasury and the Service did consider challenging formal terminations without corresponding substance. If adopted, such a policy would have prevented employers from asset stripping plans, a particular concern when the stripping leaves a successor plan that is underfunded on an ongoing basis. The policy, then, would have protected the integrity of the Code's minimum funding standards. It also would have prevented employers from using previously deducted pension contributions and tax deferred interest for general corporate purposes at a time when the plan was still being maintained.

Unfortunately, the Cabinet Council on Economic Affairs took the issue out of the hands of the taxing agencies. The Cabinet Council decided to permit employers to engage in phony plan terminations so long as the transaction satisfied certain minimal conditions concerning vesting, plan permanence and future funding amortization periods. The Cabinet Council's decision was implemented in May of 1984 with the federal pension-regulating agencies' issuance of joint implementation guidelines.

The Council's decision was in large part based on a view that plan assets in excess of plan accrued liabilities belonged to the employee. The Cabinet Council, however, also professed concern over the possibility that if employers were not permitted to engage in termination/reestablishments or spinoff terminations, they would engage in genuine terminations, followed by no qualified plan coverage or by defined contribution coverage. In a curious manner, then, the Cabinet Council purported to be acting in the interest of employees.

Even if the latter concern had been a genuine motivating factor in the Council's decision, the concerns were based on testimonial rather than empirical evidence. And there were intuitive grounds for doubting that employers would end defined benefit coverage to recover plan assets if that were the only path to a reversion. Employers sponsor defined benefit programs for many reasons, including labor considerations, relative costs of other forms of deferred compensation, and advantages to key employees. To many employers, plan termination would have been too steep a cost for recovery of

excess assets. Subsequent facts bear out this point: after the joint guidelines were issued, the rate of spinoff terminations and termination/reestablishments increased dramatically; genuine terminations continued unabated.

The Cabinet Council decision to permit employers to recover assets without terminating their plans prevented the Department of Treasury and the Service from enforcing the tax laws. The decision threatened sound plan funding and employee benefit security; it encouraged employers to view pension plans as tax-advantaged corporate savings accounts. And it was based on untested and seemingly dubious policy assumptions. If legislative change were in order it was a task for the legislative branch, not executive fiat.

C. The Tax Benefits of Surplus Assets

Current law imposes a ten percent nondeductible excise tax on plan reversions. Although this tax is often viewed by employers as a penalty tax, it is in fact intended to recover the substantial tax advantage embedded in revertible assets. The tax advantage arises because contributions to the pension plan, and the investment return thereon, are not taxed until distributed, either to a participant as a benefit or to the plan sponsor as a reversion.

Reversions should be taxed sufficiently that an employer who receives a reversion will not, after paying tax, be in a better position than an employer who did not fund revertible assets, but instead retained the portion of its contribution that could have funded the surplus, paid tax and invested the after-tax amount outside the plan. The ten percent excess tax is a rough attempt to equalize the position of the two employers.

In many plausible situations, however, the ten percent excise tax is not sufficient to recover fully the tax advantages reflected in the reversion. Legislation is needed to correct this flaw, which encourages employers to view pension plans in part as tax-advantaged savings accounts.

A related problem is that an employer effectively can realize the value of true excess assets not only by terminating a plan and recovering a reversion, but by continuing the plan and reducing contributions to reflect the excess assets. In fact, an employer who continues a plan will realize a greater tax benefit than the employer who terminates a plan, recovers plan assets and pays tax. This is because in the continuing plan the excess is not subject to immediate tax and continues to earn interest on a tax-deferred basis. Some thought should be given to whether plans with excess assets above a certain level should be required to dedicate those assets to benefit improvements or else be subject to some form of excise tax.⁵

D. Criticism of Administration's Proposals

From the perspective of the tax policy concerns discussed above, the Administration's proposals have several objectionable features. First, the Administration does not address the Internal Revenue Service's current interpretation of section 401(a)(2), which permits an employer to recover surplus assets created by the employer's decision to terminate the plan. The employer should be limited to the recovery of surplus that is due to experience gain during the plan's life.

Second, the Administration's proposal continues to permit employers to withdraw assets from ongoing plans. This practice has been justified on the grounds that it provides employers with an incentive to stay in the defined benefit system rather than terminate overfunded plans. In fact, though, there is reason to believe that many employers would choose to stay in the system even if that choice precluded access to plan assets until ultimate plan termination. If asset withdrawals were precluded, such employers might use plan surplus to improve

benefits for retirees and employees. The real question in determining whether withdrawals from ongoing plans should be tolerated, then, is a factual one: how many employers would abandon their plans because of a rule prohibiting asset withdrawals from ongoing plans. If the number of such employers is small, and the history of defined benefit plans in this country suggests that the number is indeed small, withdrawals should be prohibited.

If, however, the pension laws are to be amended to permit employers to withdraw assets from ongoing plans, those withdrawals should be limited to assets that arise because of experience gains. The Administration's withdrawal proposals are not designed to restrict employers to recovery of such assets; rather, the proposals are intended to provide plans with a funding cushion against future funding difficulties. In many cases, employers will be able to withdraw assets in excess of experience gains. If anything, this is more objectionable in an ongoing plan than in a terminated plan; it would permit an employer using a conservative funding method to create excess assets simply by changing to a less conservative method.

Third, the excise tax on reversions should be changed so that no employer is permitted to receive tax benefits from recovering assets from an overfunded plan trust. (The ten percent excise tax is too low to recover the benefits in many plausible situations.) This change could be effected by changing the manner in which the tax is computed from a universally applicable flat rate to a formula that would determine the embedded tax advantage of each particular reversion on a case by case basis. If, however, a flat rate excise tax is to be retained, the rate should be increased to a level sufficiently high to remove the tax benefits from the most tax-advantaged reversions, i.e., those in which the accumulation period for the surplus assets was longest and for which the plan's rate of return was highest. An increase to the current flat rate excise tax would, it should be noted, increase the number of plans for which the excise tax would do more than merely recover the reversion's embedded tax advantage. But the failure to adjust the present tax sends a message to plan sponsors: plan contributions that will ultimately be withdrawn from the plan are better than other forms of corporate savings because of the tax law.

FOOTNOTES

1. The regulation provided as follows:

An erroneous actuarial computation means a mistake of an actuarial character made by a careful person skilled in calculating the amount necessary to satisfy pecuniary obligations depending on the average length of life of a group of individuals . . . For example, if a trust created to supply pensions of \$25 a month for 10,000 employees for the remainder of their lives after age 60 has been used to supply such pensions only to 500 employees, an amount remaining in the trust for this reason is not due to such a mistake, but to a change in the plan; while if \$25 a month after age 60 is paid to the 10,000 employees during their lives, but their average duration of life proves less than might reasonably have been expected, an amount remaining in the trust for this reason is due to an "erroneous actuarial computation."

2. Statement of Gerald Winborne, Assistant Commissioner for Employee and Exempt Organizations, Internal Revenue Service, before the House Select Committee on Aging, September 28, 1983. See also Rev. Rul. 83-52.

3. The termination of the plan can cause actuarial surplus in other ways as well. Some actuarial funding methods result in funding portions of benefits before they actually are accrued under the plan's benefit formula, i.e., contributions are frontloaded. (Such funding methods help spread the funding burden more evenly over the life of the plan than methods that attempt to fund each year's benefit accrual in the year of accrual.) A plan on termination, though, is required to satisfy only the actual accrued benefits of participants. The terminated plan, then, may have surplus assets equal to plan funding attributable to benefits not yet accrued.

4. Throughout the Code, tax policy assumes that deductions should be permitted only for expired, irrevocable costs. There is nothing in pension policy that should allow an employer a deduction if the contribution can be treated as an employer savings account.

5. For example, the law might define excess for these purposes as the amount of plan assets in excess of the full funding limitation for the plan plus an amount of experience gain sufficient to reduce to zero plan contributions over a selected amortization period. The tax could be imposed on either the plan or the employer, and might be based on the amount of surplus (as defined for these purposes) or on the investment income produced by the surplus. It might be defensible to pay at least part of such tax to the PBGC, since in this way a part of the surplus would be used to support the defined benefit system of which the plan and its surplus are a part.

Mr. FLIPPO. Thank you very much for your testimony.

Mr. Stein, you have stated in your testimony that the current 10-percent excise tax on the pension asset that is recovered by plan sponsors is not sufficient to recover the value of this tax incentive given that these benefits are no longer used for their intended purpose. Do you think that this tax should be increased across the board or should a more exact recovery tax be used?

Mr. STEIN. Well, there are two possibilities. In some situations a 10-percent tax is not adequate to recover the tax benefits the employer would otherwise receive. In some situations, though, the tax might be considered punitive because, for instance, the period in which the surplus accumulated is sufficiently short, given the interest rates we have been seeing, that 10 percent may be more than enough to recover the reversion's embedded tax subsidy. But I think typically you would find that if most of the contributions funding the reversion were made 6, 7, or 8 years ago, a 10-percent tax will not be sufficient.

There are, as you indicate, Mr. Chairman, two ways to correct this. One would be to develop a system to try to compute what taxes the employer would have paid had he not paid excess contributions to the pension plan, but paid tax on excess contributions, and then paid taxes on the investment income that was subsequently earned.

The other possibility is simply to increase the 10-percent tax across the board or perhaps increase the tax across the board for plans in which the surplus accumulated over a moderately lengthy period of time, at high interest rates, or both.

Mr. FLIPPO. Doesn't your testimony concentrate a great deal on the reversion area. Isn't the main loss of benefits associated with asset reversion under current law, because of what is currently the unavoidable plan termination? Isn't that generally what it does and since the administration's proposal allows for withdraw of excess assets without triggering the termination, doesn't that solve the problem?

Mr. STEIN. I don't think it solves the problem from a tax perspective at all, because the Tax Code was designed in this respect to prevent employees from making contributions supposedly dedicated to pension purposes, then treating them in a contrary manner.

As to the pension policy issue, whether the employee is protected, I think only time will tell. Actuarial assumptions and procedures assume contributions and benefits being made over a long period of time. When the employee is permitted to withdraw assets from an ongoing plan, it can, even with the administration's proposals, jeopardize the ability of the employer to fund future benefits.

Mr. FLIPPO. What additional steps do you think that we should take to make termination less attractive than withdrawals?

Mr. STEIN. One possibility would simply do what the House tried to do in 1938 and again in 1942, make pension trust irrevocable. Short of that, I think a much higher tax on reversion from terminated plans might do the trick. That is, if you had an excise tax on the order of 25-percent on actual plan terminations, that would both recover any embedded income tax advantage plus impose some cost for terminating rather than continuing the plan. That

would make termination less desirable vis-a-vis continuation. Some portion of the excise tax might be used to improve benefits.

Mr. FLIPPO. Thank you.

Mr. Kaplan, you stated that the administration's funded proposal contains provisions which would inhibit the operation of employee stockowners plan, I believe. Do you have any idea where these provisions were included in the administration's proposal, what they are thinking maybe in regard to that?

Mr. KAPLAN. Yes. I think that the concept underlying these proposals with regard to floor off set plans is that by providing an offset under the defined benefits for that portion provided by the defined contribution plan, there was a greater risk and therefore, greater potential burden on the PBGC that the benefits might not be met if the employee stock in the employee stockowners plan portion of the plan didn't adequately perform up to the standards of diversified investment, that maybe in the defined in a typical benefit plan. But the point I made in my testimony is:

First, there aren't very many of these plans, so that all taken together, the idea of substantial burden on the PBGC may be really largely imaginary.

Second, there are already safeguards in the diversification requirement for employee stockowners plans, and also the proposal really doesn't consider the fact that there is increased potential reward. There may be greater retirement benefits provided under a floor offset plan. It only looks at the downside.

Mr. FLIPPO. Are you aware of any situation where a pension plan with a Federal Government arrangement has terminated with insufficient assets?

Mr. KAPLAN. I am not aware of any such occasion.

Mr. FLIPPO. Well, thank you.

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

I have no questions of these witnesses.

Mr. FLIPPO. Thank you very much.

Mr. Anthony.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Kaplan, you state in your testimony that you do oppose the early repeal of the Baucus amendment. You also state that several of the large publicly traded corporations have utilized the Baucus amendment to increase employee ownership in their corporations. I am obviously a supporter of the concept of having employees acquire ownership in these companies. I wondered if you could name some of these corporations for us?

Mr. KAPLAN. Yes, sir. Some that come to mind are Ashland Oil, Enrol, U.S. Sugar, Transco, Clark Equipment, and I know there are others, I am not aware of this morning.

Mr. ANTHONY. You mentioned H.R. 41 in your testimony. I did introduce H.R. 41 to make a number of employee stockownership plan provisions. I wanted to show my continued support for these provisions. Has your association taken a position on this legislation?

Mr. KAPLAN. Yes, sir. Employee Stock Ownership Association strongly supports H.R. 41 on the grounds that it provides certainty and clarity in planning for employee stockownership plans.

Mr. ANTHONY. I could tell from the professor's testimony that we are dealing with a very technical area. Unfortunately, it probably goes over the heads of many of the subcommittee and full committee members.

I would just suggest that you work with Treasury to see if you can work out some accommodations from their position to your position. If you have any suggestions that you could make to the members of the committee as we continue to look at it, I think it would be beneficial.

Mr. STEIN. If the committee would like, I would like to supplement my testimony with numbers showing when the ten percent tax would be inadequate and under what circumstances.

Mr. FLIPPO. That will be very helpful.

[The following was subsequently received:]

Memorandum

TO: The Subcommittee on Oversight of the Committee on Ways and Means

FROM: Norman Stein

RE: Recovering the Embedded Tax Advantage of Reversions of Excess Assets from Defined Benefit Pension Plans

At hearings on April 9th, I offered to provide this subcommittee with an explanation of why the ten percent excise tax now imposed on reversions is not always adequate to recover the tax advantage embedded in the reversion.

An employer who recovered a reversion before the Tax Reform Act of 1986 always received a tax subsidy: after the employer paid tax on the reverting assets, the reversion was still worth more than the employer's excess contributions that funded the reversion would have been worth had the employer never made the excess contributions. In other words, if the employer had not made the excess contribution, but had paid tax on it and then invested the aftertax amount on an aftertax basis, the compounded sum would not have been as large as the reversion, even after the employer paid tax on the reversion. Assuming there is no sound reason for the government to award a bonus to employers who overfund pension plans and then terminate them to recover the surplus, the tax law should ensure that the terminating employer pays sufficient tax to place him on the same footing as an employer who did not fund a reversion.

The Tax Reform Act of 1986 attempted to effect this goal through the imposition of a ten percent, nondeductible excise tax on reversions. In many situations, this excise tax is not adequate to recover the reversion's tax benefits. The three principal factors bearing on the tax advantage of reversions are interest rate, period of accumulation, and marginal tax rates. If the interest rate is large and the period of accumulation long, a ten percent excise tax is much too low, even given the lower tax rates.

Before considering the efficacy of the ten percent excise tax with respect to revertible assets that accumulate after 1986, we should first observe that the excise tax was introduced at the same time tax rates in general were lowered. In fact, the highest pre-86 corporate tax rate was decreased from 46 percent to 34 percent. This twelve percent reduction exceeds the ten percent excise tax. Thus, to the extent excess assets accumulated before 1987, the excise tax does not even lift the nominal tax rate on reversions to the rate of the corporate taxes saved during the period of accumulation. Given the lowered tax rates now in effect, an excise tax in excess of 20 percent would be necessary to recover fully the tax benefits of a reversion in 1987 that was funded gradually over a ten year period beginning in 1977 if we assume the plan's rate of investment return was eight percent throughout the period.

Looking forward, though, to reversions that were funded after 1986, the ten percent excise tax will recover the tax benefits in some but not all reversions. Below I have shown the extent of the tax advantage of reversions in a number of circumstances (that vary assumptions about interest rates and length of accumulation periods). For each situation, I have shown how large a nondeductible excise tax must be to recover the tax benefits in the reversion. I have used a model that assumes that the same percentage of each annual plan contribution funded the reversion. (This model may be viewed by some as too favorable to the plan sponsor, a criticism I will discuss below.)

In computing the tax, I have assumed certain conditions under which the surplus accumulated. Actual conditions for any given plan will, of course, vary from those I have assumed. The conditions I have assumed are as follows:

1. The plan was funded over a stated period (shown in the following charts and referred to as "accumulation periods") with a level annual contribution for each of the years in the stated period. The contributions were made at the start of each year, so a 10-year accumulation period assumes 10 contributions and 10 years of investment growth on the first contribution, 9 years of investment growth on the second contribution, and so on.
2. The employer had a marginal tax rate of 34 percent at all times.
3. The interest rate was constant throughout the period; interest was compounded monthly. (The charts below use interest rates of eight, ten, twelve and fourteen percent.)
4. The plan's excess assets come into existence at the time of reversion; they are probably attributable to deviations between the manner in which benefits are valued on plan termination and the manner in which benefits are projected under the plan's actuarial funding method. The plan experienced no gradual experience gains.
5. No benefits were paid during the accumulation period, nor did the employer previously recover a reversion from the plan.

15 Year Accumulation

Interest Rate	Excise Tax Necessary to Neutralize Tax Benefit
14%	25%
12%	22%
10%	18%
8%	15%

12 Year Accumulation

Interest Rate	Excise Tax Necessary to Neutralize Tax Benefit
14%	20%
12%	18%
10%	15%
8%	11%

10 Year Accumulation

Interest Rate	Excise Tax Necessary to Neutralize Tax Benefit
14%	17%
12%	15%
10%	12%
8%	10%

8 Year Accumulation

Interest Rate	Excise Tax Necessary to Neutralize Tax Benefit
14%	14%
12%	12%
10%	10%
8%	8%

5 Year Accumulation

Interest Rate	Excise Tax Necessary to Neutralize Tax Benefit
14%	9%
12%	8%
10%	7%
8%	5%

As I have noted, the above charts were prepared under a model that apportions part of the reversion's funding to each plan contribution. In the charts, for purposes of illustration I have assumed that funding was level, i.e., the same dollar contribution was made in each year.

If funding were not level, an appropriate excise tax could be derived by assuming that a prorata portion of each plan contribution funded the reversion. (For example, if the reversion constituted 25 percent of all plan assets, it would be assumed that 25 percent of each contribution funded the reversion.) The excise tax would be applied separately to each excess contribution and the investment growth it produced. The rate applied to each such excess contribution would vary depending on the period of accumulation and the applicable interest rate. In effect, the total excise tax would be the sum of these separate taxes.

If contributions were larger during early years plan years, a greater percentage of the reversion (as well as the nonreverting plan assets for that matter) would be attributed to the contributions in earlier years (and cause a higher excise tax than in the level funding examples shown above). The charts below show what excise tax would be appropriate (given a particular interest rate) for each excess contribution. The longer the period of accumulation (the time between the contribution and the employer's recovery of the excess assets), the larger the excise tax would need to be to recover the embedded tax advantage.

14% Interest

Period of Accumulation For Contribution	Excise Tax Necessary to Neutralize Tax Benefit
15	33%
10	25%
5	14%

12% Interest

Period of Accumulation For Contribution	Excise Tax Necessary to Neutralize Tax Benefit
15	30%
10	23%
5	12%

10% Interest

Period of Accumulation For Contribution	Excise Tax Necessary to Neutralize Tax Benefit
15	26%
10	19%
5	10%

8% Interest

Period of Accumulation	Excise Tax Necessary to Neutralize Tax Benefit
15	22%
10	16%
5	8%

Computing an excise tax on the basis I have suggested would involve factors not discussed here. For example, provision would need to be made for benefits paid out and previous reversions.

Devising a formula to recapture precisely a reversion's embedded tax advantage would be a complicated but possible undertaking. A less precise but perhaps more manageable approach to reforming the current excise tax would be to prepare "rough justice" tables that would take into account different plan rates of return and different accumulation periods.

I also want to note one concern, which I alluded to earlier. My examples assume that the taxation of the reversion should assume that each plan contribution funded a prorata portion of the reversion. However, since the employer could have funded the nonrevertible plan assets by forgoing its earliest contributions to the plan, it could be argued that it is proper to assume a first-in funding model, i.e., that the reversion was funded with the first contributions. This would, in many situations, result in a dramatically higher excise tax than suggested by the above examples. For example, assume an employer makes its first plan contribution fifteen years before the reversion. If the first contribution, plus interest thereon, equals the amount of the reversion, and the plan had interest growth of 14 percent for the period, the excise tax would need to be 33 percent to neutralize the tax subsidy. In other words, the total tax on the reversion would need to be 67 percent (34 percent ordinary tax plus 33 percent excise tax).

While a first-in funding model can be justified, the method used in my calculations seems more supportable. It is based on the actual contribution pattern of the employer during the plan's life and not on a theoretical construct designed to maximize tax (or for that matter, minimize tax, since a last-in funding model might also have its supporters). The method used here can also be defended as sitting on a middle ground.

Mr. ANTHONY. Mr. Kaplan, you also seemed to emphasize the potential negative impact of the administration's proposal on existing employee stock ownership plan companies with floor-offset plans.

Forgive me if this was asked by the Chair in my absence. I had a subcommittee meeting four doors away to report out the catastrophic health bill to the full committee, so we are running back and forth today.

I wondered if you could explain in more detail, if you have not already done so, for the record.

Mr. KAPLAN. Yes, sir. That question has not been asked. In a classically held company, the administration proposal might put a company in a position of having to buy or book its own shares from the defined contribution part of a floor-offset arrangement; namely, the employee stock ownership plan, at the same time that it is called upon to provide funding for the defined benefit portion. That would put, in many cases, a completely unplanned and unbudgeted demand on the cash flow of the capital, which is not the case of privately owned companies. Without access to the capital markets, the way public companies are could put them under very heavy cash burden.

Mr. ANTHONY. Are you familiar with the Mad Butcher?

Mr. KAPLAN. I am aware that the Mad Butcher has an employee stockownership plan.

Mr. ANTHONY. They are 100-percent owned. They are also in the Fourth Congressional District in Arkansas, so I keep an eye on them. I wondered if you have any information as to whether or not this would impact on an employee stockownership plan such as the Mad Butcher. If you don't have the personal knowledge, maybe you could check it out through your association.

Mr. KAPLAN. I don't know whether the Mad Butcher has a floor-offset arrangement, but I will certainly find out and let you know.

Mr. ANTHONY. I would be interested in a more parochial manner.

You testified for the broad spectrum on the policy. I would like to see how it impacts on one that has worked very, very successfully in my home area to see how it would impact more particularly on employees of a 100-percent employee stockownership plan.

Mr. ANTHONY. I thank you, Mr. Kaplan and Mr. Stein.

Thank you, Mr. Chairman. I yield back.

Mr. FLIPPO. Thank you, Mr. Anthony.

Gentlemen, we appreciate very much your testimony today. It is very helpful to us and we will conclude. Your full testimony is in the record and we appreciate your sharing your particular viewpoints with us.

Thank you very much.

[Whereupon, at 10:40 a.m., the hearing was adjourned.]

[Submissions for the record follow:]

Statement of
C. H. Barnette
Senior Vice President and General Counsel
Bethlehem Steel Corporation
Subcommittee on Oversight
House Ways and Means Committee
April 7, 1987, Oversight Hearing on
Overfunding and Underfunding of Pension Plans

Bethlehem Steel Corporation is pleased to submit for the record of this hearing its comments on the Administration's Proposal for changes to the Funding and Termination of Defined Benefit Pension Plans.

Bethlehem supports both the stated objective of the Administration's Proposal -- to improve benefit security for participants -- and the policy concepts underlying the proposed changes. We understand that the purpose of the Administration in presenting this Proposal is to implement reasonable changes now in order to reduce the potential for underfunded pension plans in the future. The provisions which would permit employers to use surplus pension assets to fund post-employment health care benefits also deal with the important issue of unfunded retiree health care costs. The Proposal does not, however, recognize the serious and unique problems faced by companies, such as Bethlehem, which currently must deal with underfunded pension plans in an industry that has been and is restructuring and have experienced a recent dramatic increase in their pensioner-to-employee ratio and their pension payroll.

The domestic steel industry remains in a state of financial crisis. Attached for the record is a Survey that we have prepared on the condition of the domestic steel industry.

For companies such as Bethlehem, those aspects of the Proposal dealing with overfunded plans are not, of course, immediately applicable. We have not seen any proposed transition rules; however, the strict application of the proposed new minimum funding rules, particularly the shortening of the amortization period and the cash flow rule, could have a serious adverse effect on certain plan sponsors. Businesses generate a specific cash flow, and legislating a new cash requirement on plan sponsors could jeopardize the ability of some sponsors to maintain an adequate level of liquidity. For example, in Bethlehem's case, the application of the cash flow rule might require a yearly pension contribution of as much as \$500 million. This is greater than Bethlehem's cash position at December 31, 1986. For comparison purposes, Bethlehem's required contribution in 1987 for 1986 is currently estimated to be \$150 million. Furthermore, the proposed minimum funding waiver rules would appear to preclude the possibility of a waiver of any kind.

In many cases where plans are significantly underfunded, plan sponsors clearly do not have the financial ability to make greatly increased cash contributions and are in need of funding waivers. The likely effect of subjecting such plans to certain of the proposed new rules, such as the greatly increased pension fund contributions mentioned above, could force plan sponsors to consider termination of their plans and the transfer to the PBGC of such obligations and possibly to even consider seeking the protection of the Bankruptcy Code. This result would be contrary to the public interest and the overall best interests of retirees, employees, the PBGC and plan sponsors. Accordingly, any legislation must take into consideration the precarious financial condition of many plan sponsors and provide some form of protection for plan sponsors potentially faced with economically unrealistic funding requirements which could have the adverse results described above.

We believe that the domestic steel industry in general, and Bethlehem in particular, have special problems which are not addressed by the Administration's Proposal. As the attached Survey shows, despite the extraordinary actions taken by the industry to help itself, the industry remains plagued by overcapacity, high import levels, severely reduced selling values, large increases in the number of retirees, etc. In Bethlehem's case, its pension plan's provisions for early unreduced benefits and periodically improved benefits over past years were established, generally as a result of collective bargaining, prior to the onset of these problems and at a time when they were foreseen as reasonable and within the company's ability to adequately fund them. The present underfunded status of its plan is, therefore, directly or indirectly attributable to a combination of factors over which Bethlehem had no or relatively little effective control. These include (1) an increasingly depressed economic environment referred to above which has required, and will require, the restructuring or closing of various facilities, thereby triggering eligibility for benefits which were not provided for in the actuarial assumptions used for funding purposes, (2) the extreme difficulty of making significant changes in benefit provisions which had been legally negotiated in collective bargaining and (3) insufficient funds due to poor earnings to make additional contributions to offset the increasingly higher pension benefit payments.

The Administration has recognized that the domestic steel industry is in a state of financial crisis. Since last October, an interagency task force of the Economic Policy Council, chaired by Bruce Smart, the Undersecretary of Commerce for International Trade, has been studying a broad range of public policy options which may be necessary or appropriate to facilitate further restructuring of the industry and optimize the opportunity for longer term financial viability. Bethlehem has worked closely with the task force and will continue to do so to both provide data and offer our best judgment and recommendations as to alternative public policy responses that might be appropriate. We are confident that the task force's report to the Cabinet Counsel will address the critical issue of the industry's retiree pension and health care liability and the need to balance painful restructuring requirements with the rights and expectations of the industry's present and future retirees.

We therefore urge that when the Administration's Proposal reaches the legislative drafting stage the unique problems of the domestic steel industry be addressed separately as part of a comprehensive legislative program to insure the continuation of a viable privately-owned domestic integrated steel industry.

YEAR-END 1986 SURVEY
DOMESTIC STEEL INDUSTRY

A. The Industry Situation

1. The steel industry is in very serious financial condition.
2. Despite costly shutdowns of 42 million tons of capacity since 1981, operating rates remain in the 60-70% range.
3. Imports' market share has been higher than ever before in the last three years at an average of 25%.
4. The decline in domestic capacity and production over the past five years has been unprecedented.
5. Excess capacity of 200 million tons is a worldwide problem.
6. No other countries have experienced the sharp decline in steel production that has occurred in the United States.
7. To offset poor financial results and aid in restructuring, EC governments have provided \$40 billion in subsidies to their steel producers since 1975. Comparable amounts have been advanced in third world countries.
8. The United States is the only major steel producing nation in the free world that is a net importer of steel.
9. The surge of imports has extended to the products of customers, resulting in an additional loss of over 8 million tons in 1986.

B. What The Industry Has Done To Help Itself

10. Despite reduced volume, labor productivity has increased more than 25% in man-hours per ton since 1981.
11. The percent of steel which is continuously cast has more than doubled since 1981, is now over 50%, and still rising fast.
12. The industry spent \$7 billion, or 170% more than its cash flow between 1982 and 1985, to maintain and modernize its facilities.
13. The number of employees has been cut by more than 55% since 1981 from 391,000 to 174,000 in 1986.
14. The industry's work force has contributed to improving the industry's financial performance.
15. Labor productivity for carbon steel in the United States is the best in the world at 6.3 man-hours per net ton.

C. Why The Industry Problems Persist

16. For firms in a cyclical, capital intensive business, the balance sheets and bond ratings of major producers are very weak.
17. Cuts in steel costs since 1981 have been more than offset by reductions in selling value.

18. Import prices remain 20% below the 1982 level despite VRA's and the weaker dollar.
19. The steel industry's ratio of active workers to retirees has gone from 2.3 in 1977 to 0.5 in 1986.
20. Costs of employee benefits for retirees are increasing and are now 10% of current employment costs.
21. Companies in Chapter 11 transfer costs to the Federal Government and others, creating unfair advantages over the rest of the industry.
22. At least 24 companies, representing more than 20% of industry are in, or have gone through, bankruptcy proceedings.
23. Weaker dollar has not been reflected in rising import prices.
24. Higher exit barriers make facility shutdowns very expensive and exacerbate the overcapacity problem.

D. Conclusion and Alternatives

1. It is in the national interest to have a privately owned, internationally competitive, integrated domestic steel industry.
2. Chapter 11 was not intended for, and is not appropriate for, restructuring an entire industry.
3. Continued actions by domestic companies and others are required.
4. Specific government actions are appropriate in at least three areas:
 - a. Restructuring and exit barriers
 - b. Modernization and technology
 - c. Trade

[Supporting exhibits are available upon request.]

STATEMENT
OF
NATIONAL SMALL BUSINESS UNITED
SUBMITTED TO THE
SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS
HOLDING HEARINGS ON
THE ADMINISTRATION'S PENSION PLAN FUNDING
AND PREMIUM RATE PROPOSALS
APRIL 7 and 9, 1987

Mr. Chairman and Members of the Committee:

This statement is being submitted on behalf of National Small Business United (NSBU). NSBU is a new, national trade association formed from the recent merger of the National Small Business Association, a multi-industry trade association founded in 1937, with Small Business United, a coalition of regional, state and metropolitan small business associations organized in 1981. NSBU represents over 50,000 small businesses nationwide.

The NSBU sincerely appreciates the opportunity to present the views of small business on the Pension Benefit Guaranty Corporation's proposal to initiate a variable rate premium system.

Pensions are important to small business. Many thousands of small businesses are formed each year, and at the time they are started, they may have an expected future of only 4 or 5 years on the average. A great many small businesses go under after a few years, but a handful go on to become giants. These small businesses generate a substantial share of new products, new inventions and new jobs. Small business is extremely important to the U.S. economy.

Small businesses rely on pensions far more heavily than large companies. With an uncertain future, they must demonstrate financial soundness in their pension plan at least. Small businesses have minimal clerical forces and administrative facilities. Complicated government rules and regulations fall on them much more heavily than on large corporations. In recent years, small businesses have been forced to abandon defined benefit pension plans because of the complexity of top heavy rules, qualified domestic relations orders, complicated funding

requirements, a host of federal forms, etc. The gist of the proposal by PBGC is to increase the complexity by a full measure and then some. This must, of necessity, force even more small businesses to drop existing pension plans and serve as an impediment that prevents some newly formed businesses from ever adopting a pension plan.

The PBGC proposal does make one concession to small business in its exemption of plans with fewer than 100 participants from the funding charge which they propose. This is really not much help. Either a small business must establish a second plan when it gets up to 80 or 90 participants, or it will find itself in the position of taking on a substantial added cost just by hiring one more employee. In addition, many small plans do not conduct actuarial valuations which would permit determination of the proposed funding charge except at 3-year intervals. Any requirement to calculate the charge annually, once there are 100 participants, would add a considerable amount to plan costs.

An aspect of the PBGC proposal that is very troubling for small business is the idea that a controlled group should have its plans pooled together in some way. Small businesses are bought and sold frequently and, under the PBGC proposal, the status of funding a pension plan could well be sufficient to make or break a deal. The owner of a small business may well start up a second business in order to provide some stability of income and credit facilities. The owner needs to keep these businesses in separate watertight compartments in order to fully insulate each of these fledgling businesses from the possible failure of one or more of the others. Taking pension surplus or deficiencies from one business and imposing them on other businesses, that happen to be owned by the same individual, not only creates confusion and puts roadblocks in the way of effective sale and establishment of such business, it may also affect the availability of credit. NSBU is unalterably opposed to this new extension of the controlled group concept.

The PBGC has issued a thorough study of their program, "Promises at Risk". After they have put so much time in studying the claim experience up to the present time, it is surprising

that they should design a new system which ignores the fundamental causes of loss. It is obvious, after reviewing their study, that most of PBGC's losses are due to four causes - (1) plant shutdown benefits, (2) 30-and-out and other heavily subsidized early retirement benefits, (3) lump sum settlements, and (4) waiver of funding contributions.

None of these prime causes for PBGC loss are traceable to small companies.

- o Plant shutdown benefits have been offered only by large corporations which have negotiated them with unions. They are never found in the pension plans of small employers.
- o Small employers may, from time to time, have subsidized early retirement benefits, but almost never provide benefits as generous as the 30-and-out supplements found in the auto industry.
- o Small business rarely asks for a waiver of funding contributions because such a waiver would only be worthwhile if the amount involved is significant and would warrant the expense necessary in getting legal and tax counsel involved in filing for the waiver.

A few small businesses still operate defined pension plans and do have participants covered under those plans. Some may have unfunded vested liabilities in those plans. The PBGC proposal would ask those smaller businesses to pay for the losses imposed on the system by large companies with these "pop-up" type retirement benefits which are unlike those found in small company plans. NSBU thus objects strenuously to having this large company deficit imposed on the few small businesses that can still operate a defined benefit pension plan.

We believe that the PBGC was imprudent in incorporating plant shutdown benefits and early retirement supplements in the basic benefit which they were authorized by ERISA to insure on a mandatory basis. Rather, we believe these unusual benefits (plant shutdown, 30-and-out, etc.) should have been properly insured under the second revolving fund authorized by ERISA Section 4005(a) to be used for "non-basic" benefits. Then, if the unions which negotiate 30-and-out or plant shutdown benefits wish to have insurance from PBGC as to those features, the PBGC could establish a second premium to be paid by those groups into the second trust and those unions could negotiate with their employers to obtain the coverage. Surely it makes no sense to try to force the cost of such unusual non-basic benefits across the entire range of plans, including all of the small businesses which still operate pension plans but which do not have such superduper benefits.

The proposed variable rate premium is to be based on the excess of 125% of vested liabilities over assets. Unfortunately, vested liabilities do not incorporate any of these four sources of loss. Plant shutdown benefits are generally not included in a plan valuation until a shutdown actually occurs and then they appear as a huge actuarial loss. Early retirement benefits may be funded on an ongoing plan basis (assuming that 10-20% of the employees will retire when eligible). When a company is about to go out of business, almost 100% of the employees eligible for early retirement elect to take advantage of the program. Lump sum options are usually considered to be actuarially equivalent to the pension liabilities already being valued, even though, from time to time, the basis for the lump sum can be considerably more favorable than a current market rate. As to waivers, the funding status of a plan at one point in time clearly does not take into account the possibility of continued future benefit accrual without any contribution being made. The PBGC proposal thus fails to capture the most important elements in the risks they are underwriting. Small companies starting up a new plan will be asked to pay an "underfunding" premium, even when they are paying as much into the plan as the IRS allows.

In 1986 Congress passed legislation requiring an employer, who terminates a pension plan in the standard manner, to pay for any deficiency that exists. This suggests that the PBGC's liability in the future depends on the excess of vested liabilities over the sum of the plan assets and a portion of employer net worth. To consider just plan assets ignores this 1986 legislation.

Finally, we would observe that the PBGC proposals on premiums, coupled with the proposals for extremely rapid funding, place total emphasis on the funding of pension plans. From the PBGC's viewpoint, this reduces their risk of loss and permits them to operate productively in a responsible manner. They cannot, therefore, be faulted for raising a proposal that is so extreme. On the other hand, defined benefit pension plans also provide benefits. They have been extremely useful in the past in enabling an employer and a union to pay benefits to people who are old today, not 40 years from now. One of the funding proposals we have heard of would require an employer, with less than 80% of his vested benefits funded, to make no more benefit improvements and to pay for the underfunding over a 3-year period. In a sense, this destroys the usefulness of a pension. To draw a parallel, how many people in America would own homes if they were required to put 75% down and pay the balance off in 3 years? Even though some financial uncertainty remains, we are better off taking care of the people who are old today and who need income today.

The PBGC proposal focuses on accrued rights some of which may not be paid for 40 or 50 years. If there should be substantial inflation in the future, these promises made by the PBGC will prove to be meaningless because the purchasing power of the benefit may have shriveled up to a mere pittance. It would certainly be a shame to have the PBGC solve its financial problem in such a way that it discourages companies from offering private pension plans or improving them for their employees. In particular, it would be unfortunate if employers who are thinking of

improving pensioner benefits to offset a rise in the cost of living, were to be required to put so much money in the fund that they simply are unable to do so. Truly, this would be destroying an effective personnel tool that is accomplishing good today merely to shore up the federal insurance program that is intended to support that vehicle and encourage its spread among employers generally. NSBU believes more employers should be encouraged to provide pensions for their employees, to improve them when they can afford to, and to try to offset some of the disastrous effects of inflation. The PBGC may need help but it should not be at the expense of the pensioner.

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Donald E. Reed
 Vice President
 Government Affairs

NYNEX

April 3, 1987

J. J. Pickle, Chairman
 Subcommittee on Oversight
 of The House Ways and Means
 1105 Longworth House Office D
 Washington, D. C. 20515

Dear Chairman Pickle:

I am writing on behalf of NYNEX Corporation regarding the Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans, in particular that part of the proposal entitled Retiree Health Benefits. We strongly support the policy underlying the Administration's proposal to permit the transfer of assets from a defined benefit pension plan to a welfare benefit fund. However, we have a serious concern with one aspect of the proposal and, as a general matter, we do not think the proposal goes far enough in encouraging employers to fund health care benefits.

NYNEX Corporation is a service-provider in the information industry with offices in thirty-three states. Its two major subsidiaries are New England Telephone and Telegraph Company and New York Telephone Company. NYNEX and its subsidiaries employ approximately 90,000 people and have approximately 45,000 retirees who are presently receiving pension benefits from one of the NYNEX sponsored pension plans. These pension plans are responsibly funded consistent with the letter and intent of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

NYNEX provides comprehensive health care benefits to its 45,000 retirees on an unfunded basis and is presently evaluating the availability of pre-funding these benefits. The Administration's proposal would permit, with certain restrictions, and without a tax liability, the transfer of assets from a pension plan to a retiree health welfare benefit fund which provides health benefits to current retirees and is exempt from income tax. We support this proposal as it would significantly facilitate the ability of employers to pre-fund the health benefits of present retirees.

Chairman Pickle
April 2, 1987

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We are, however, concerned about the Administration's proposal to eliminate section 401(h) of the Code. As discussed in the proposal, under current law section 401(h) is the only alternative available to an employer to pre-fund post retirement medical benefits on an ongoing basis with tax-deductible contributions on which earnings are tax exempt. Its repeal would be detrimental to NYNEX and other companies, and would not serve the Administration's policy goals. The only reason given for the proposed repeal is that, to date, little use has been made of section 401(h) which in part may be because of the limited scope of this provision. If so, the remedy should be to expand rather than to repeal section 401(h), particularly since employers face increasing health-care obligations in the future. NYNEX therefore believes the Committee could significantly improve the Administration's proposal by retaining and even extending the scope of section 401(h).

In addition, NYNEX urges the Committee to expand the Administration's proposal to allow employers to pre-fund, on the same basis proposed by the Administration for current retirees, the post-retirement health benefits of current active employees. Such legislation should encourage employers both to pre-fund health benefits and, in the case of those employers who do not offer health benefits to retirees, to consider providing such benefits.

Prior to the enactment of the pension funding requirements under ERISA, even some well-intentioned employers failed to keep their pension promises to employees due to unforeseen changes in economic conditions. The same situation exists today with respect to health care. Legislation incorporating the Administration's proposal, with the modifications described above, and with actuarially sound funding provisions, would encourage those employers who offer retiree health care coverage to pre-fund it and would also encourage other employers to consider providing their retirees with a health care benefit.

NYNEX feels that this would have two very positive results. First, more people would receive employer sponsored group health care coverage, thus reducing the pressure to expand Medicare coverage. Second, employees would attain the same sense of security about an employer's promise for health care coverage as ERISA has brought them about an employer's pension promise.

NYNEX thanks the Subcommittee for the opportunity to be heard on this subject and would be glad to assist in drafting legislation to implement the Administration's proposal.

Very truly yours,

Donald B. Reed

Donald B. Reed

STATEMENT OF
PACIFIC TELESIS GROUP
ON
THE ADMINISTRATION'S PENSION
PLAN FUNDING AND PREMIUM RATE PROPOSALS

Introduction

Pacific Telesis supports the underlying concepts of the Administration's proposal as an important step toward encouraging optimal plan funding and strengthening the single employer defined benefit pension plan insurance system. We believe there is a need to better protect participant benefits and more fairly treat employers who responsibly fund their plans.

We place great importance on a balanced approach combining retirement income needs in an ongoing plan along with funding and other provisions in a terminating plan. In addition, we feel that the criteria for any new standards must be simple, equitable and avoid any unreasonable burden. This can be accomplished, in part, by using measurements that are readily available from data a company produced in the normal course of business. In addition, Pacific Telesis strongly believes that tax deductions should reflect any changes in the funding requirements. Since the funding proposals and the premium structure changes should have the same primary objective of strengthening the benefit security of plan participants while reducing the potential liability of the PBGC, any solution to the financial problems of the defined benefit system should address both of these issues as a part of a single, well-coordinated reform package.

Observations

While we agree that the minimum funding standards should be strengthened, we do not support all of the specific measures proposed by the Administration. In addition, we find parts of the Administration's funding proposal too complex. Pacific Telesis' perspective on the proposal can be summarized in four points:

1. We support a variable PBGC premium that is determined by both a risk and exposure related measurement
2. We favor increasing the minimum funded standards, including tightening amortization periods, restricting funding waivers, and accelerating the due date for pension contributions
3. We agree that excess assets should be transferable, on a tax-free basis at the employer's option, to fund health care benefits for current and future retirees
4. We have reservations about the controlled-group concept that runs throughout this proposal

Details of Pacific Telesis' views on the funding and PBGC premiums for single employer defined benefit plans are described below.

PBGC Premium Structure

Long term PBGC premium structural reforms are needed if the PBGC is to avoid the kinds of losses it has recently sustained. PBGC insurance covers risks related to both market fluctuations and the inability of sponsors to sufficiently fund their pension promises. A variable rate premium would continue to provide this coverage and, at the same time, help restore the health of the PBGC's single-employer pension insurance program without adversely affecting soundly funded defined benefit plans.

A variable rate premium is a more equitable approach to allocating insurance costs than the current flat rate premium. Under the proposed variable premium, all covered plans would pay a flat charge per participant. In addition, plans that represent greater potential exposure for the PBGC would also pay a variable "funding charge". Pacific Telesis believes that it is reasonable to correlate the funding charge to the amount of underfunding in the pension plan and to spread the current PBGC deficit and the PBGC's administrative expenses among all sponsors of defined benefit plans through the flat charge. In general, we feel that a variable premium that is higher for underfunded plans is the best way to make this program work and, at the same time, to strengthen the defined benefit pension plan system.

However, we feel that the Administration's Variable Rate Premium (VRP), which relies exclusively on the plan's funded status, fails to take into account the time available for the employer to fund the plan. A variable premium reflecting the degree of underfunding and the maturity of the population would accommodate both the risk and exposure elements. Although more complex than the flat \$8.50 rate per plan participant, such a variable premium could be simplified if readily available plan data/information were used in calculating the premium. This risk and maturity related premium would provide the revenue in a way that equitably allocates premium costs, create incentives for better funding, and keep premiums at the lowest level consistent with the PBGC's financial health.

Pacific Telesis is convinced that Congress should determine future PBGC premium rates. The premium rate is too important to the health of the private pension system to be subject to PBGC's discretion or automatic indexing. And, assuming the new funding proposals work, we feel it would be inappropriate to index the PBGC premiums, since there would be no direct correlation between the PBGC cash requirement and inflation. Pacific Telesis stresses that Congress should have the power to determine the PBGC premium rates after careful evaluation of the PBGC's cash needs.

On other related PBGC issues, Pacific Telesis feels that the level of PBGC insured benefits should remain the same as under current law and that other sources of revenue for the PBGC should be explored, such as earmarking the excise tax on reversions.

Maximum Funded Standards

Pacific Telesis advocates sound funding as the primary means of strengthening the benefit security of plan participants and of reducing the potential liability of the PBGC. We have a serious commitment to the sound funding of private pension plans since we believe that private pension plans play a vital role in providing retirement security for our nation's workers. We also believe that private pensions will not be able to fulfill that role unless they are sufficiently funded to deliver the benefits they promise. However, since the private pension system is voluntary, minimum funding standards

must strike a balance between the need for pension plans to be soundly funded and the need to preserve and expand the voluntary pension system.

The Administration's proposed minimum funding rules would limit PBGC's exposure to large losses by preventing employers from maintaining plans that are grossly underfunded, minimizing their contributions and then escaping responsibility for fulfilling their pension promises. In addition, the proposal would improve the funding of severely underfunded plans and reduce the likelihood that plans will become severely underfunded in the future.

Changes to the funding standards should be viewed as long-term solutions to the PBGC's financial stability. Pacific Telesis agrees with these changes and supports increased minimum funded standards that balance the viability of a defined benefit arrangement with the employer's financial abilities. We also support enhancing PBGC's voice in granting premium waivers and linking any annuity provisions to non-par annuity arrangements.

In addition, we feel that the restrictions placed on a plan and the plan sponsors should depend on how far the plan falls below the minimum funded standards. For example, if the plan did not meet the minimum funded standards it should not be granted funding waivers. At a lower level of funding, plan participants should be notified of the plan's funding deficiency and no benefit improvements allowed. At a still lower level, benefits should be frozen and a surcharge should be levied to upgrade the plan's funded status.

We also feel there should be a strong linkage between the benefits guaranteed by the PBGC, the PBGC charge and the funding of these benefits. For example, employers should not pay insurance premiums to the PBGC for benefit promises that are not yet guaranteed by the PBGC. This can be accommodated if Congress lengthens the PBGC phase-in period and allows employers to use the lengthened phase-in period to fund their plans' benefit.

If new funding requirements are limited to new liabilities and are gradually phased in over a number of years, we believe that plans could be funded faster without disrupting the defined benefit pension system and without creating undue economic hardships for those employers who are already experiencing serious financial difficulties. Reasonable transition rules would have to be developed for these new, stricter funding standards. Since the proposed amortization requirements are a drastic departure from current law, a long transition period should be added to this proposal to help companies with underfunded plans meet the new standards. For companies that have always complied with current law in making their funding decisions, it is imperative that rational and workable transition rules be provided to prevent any undue financial burdens.

The Administration's proposal does not define the minimum benefit security level or the interest rate used in its calculation. These definitions are needed. In addition, we feel the process of evaluating plan asset sufficiency should be simplified. The additional administrative costs for the new rules and the advantages of requiring additional calculations must be weighed against the added costs of calculating liabilities several times for different purposes. Although the incentives for increased pension funding contained in this proposal would probably not cause large changes in the behavior of most plan sponsors, we feel the proposed stricter funding standards will make more employers accountable for their pension promises.

Transfer of Excess Assets to Health Plans

Although we do not believe that overfunded plans pose a risk to the defined benefit system or present a problem which Congress needs to address, we do support the proposal to allow withdrawals of excess assets from pension plans without requiring a plan termination. Permitting reversions is important to encourage companies to fund their pension plans responsibly. It also acknowledges that companies that bear the risk of underfunded plans should have access to excess funds once all promised benefits are paid to participants. A withdrawal policy that allows an adequate safety cushion and is simple for employers to use would enable them to have access to their funds without requiring the termination of the plan. We strongly support this, since we feel the defined benefit promise is a promise of a specified pension benefit, not the assets in the trust fund. Therefore, as long as the specific benefit level is met, we feel any excess funds belong to the employer. This belief is consistent with the practice of giving the employer the ability to transfer, without adverse tax consequences, a portion of the excess pension plan assets to other business interests. We support these concepts since they allow the optimal use of excess assets without affecting the defined benefit plan promise.

Pacific Telesis feels that the Administration's proposal on excess assets could be improved as follows: The definition of excess assets needs strengthening. The excess assets should be used in the following order: correct underfunding for other plans in the controlled group, fund post-retirement health benefits for both retirees and current actives at the employer's option and finally, for general corporate use. However, we do not support that section of the proposal which would make it more difficult than current law for a plan sponsor to have access to his excess assets.

In regard to funding post-retirement health benefits, Pacific Telesis feels that further study is needed and, perhaps, should be postponed until the FASB issues its statement on this topic in 1988. However, we question the need to repeal Code Section 401(h), which currently provides one of only two tax-favored mechanisms for pre-funding retiree health benefits.

Controlled Group Concept

Pacific Telesis disputes the controlled group concept in the Administration's proposal. The rules appear to permit wholesale transfers of assets among plans in a controlled group, in apparent inconsistency with the exclusive benefit rules of current law. Moreover, mergers and acquisitions would be made far more complicated, since any transfer of a pension plan outside the employer's controlled group would be treated as a plan termination. In addition, Pacific Telesis feels that it would be wrong to require that pension plans in one line of business subsidize the pension liabilities incurred by another line of business. Although especially true for a regulated entity, it also would affect government contractors, negotiated plans and even plans requiring employee contributions. Pacific Telesis strongly advocates minimizing cross corporate subsidies.

Summary

Pacific Telesis applauds the Administration for examining the funding of qualified defined benefit pension plans and the PBGC rate structure. We concur with the underlying philosophy of the proposal and support improving the funding of pension plans and securing adequate premium income for the PBGC.

At this stage, the Administration's proposal is conceptual in nature and will require a great deal of time to refine. Pacific Telesis hopes to provide additional insights to clarify the direction of the proposal as it matures. Pacific Telesis appreciates the opportunity to comment on the initial proposal and looks forward to working with the Administration and Congress in developing a final product that will sustain a healthy, viable defined benefit pension system in the United States.

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